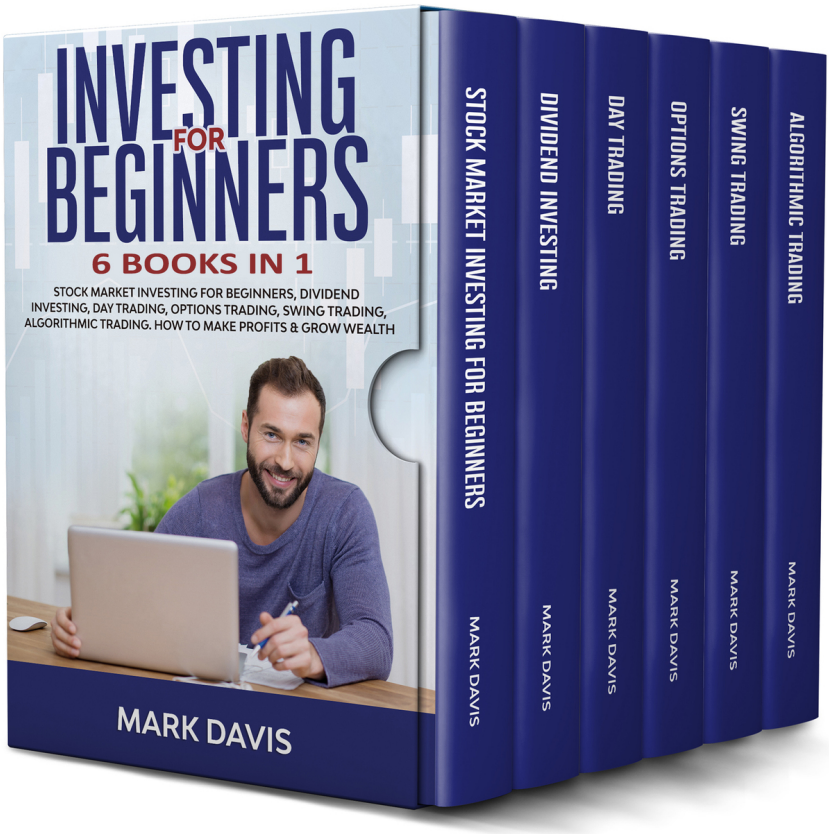

INVESTING
FOR
BEGINNERS
6 BOOKS IN 1
STOCK MARKET INVESTING FOR BEGINNERS, DIVIDEND INVESTING, DAY TRADING, OPTIONS TRADING, SWING TRADING, ALGORITHMIC TRADING. HOW TO MAKE PROFITS & GROW WEALTH
MARK DAVIS
STOCK MARKET INVESTING FOR BEGINNERS
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INVESTING FOR BEGINNERS 6 BOOKS IN 1

(Stock Market Investing for Beginners, Dividend Investing, Day Trading, Options Trading, Swing Trading, Algorithmic Trading. How To Make Profits & Grow Wealth)

Mark Davis

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STOCK MARKET INVESTING FOR BEGINNERS

The EASIEST GUIDE to Learn the BASICS of Stock Market, Start Creating Your WEALTH and Pursue Financial Freedom with Proven STRATEGIES

Introduction

Congratulations and welcome to Stock Market Investing for Beginners. In this short but informative guide, we hope to give you the knowledge that will empower you to take control of your own financial future!

Stock market investing provides an unprecedented way to grow your income and wealth. In this book, we will introduce you to the stock market and show you how to invest efficiently and effectively, using time-tested strategies that will help to minimize your risk. Most people set up a 401k or IRA and don't give any further thought to their retirement plans. In this book, we will dive into managing your portfolio yourself so that you – and not some paid advisor – can direct where your portfolio goes, apply your own investment strategies, and pick investments that you believe will grow your income and wealth.

In this book, we will cover everything you need to know in order to get started. We will explain what to look for when buying stocks and show you how to trade online, using some exciting commission free opportunities with mobile apps. We will also explore different ways you can get into stocks, including buying individual stocks, exchange-traded funds, and mutual funds. Then we'll enter the world of bond investing and not only see how you can invest in bonds, but we'll look at ways to leverage the stock market to do it. Then we'll discuss mutual funds and give you the information you need in order to weigh whether or not they are worth it for your situation.

We'll also discuss more advanced techniques such as options trading, day trading, and swing trading. Finally, we'll review some common beginners' mistakes to help you mitigate your own risks.

Thank you for downloading this book. I hope that you find it informative and that it helps you build your own highly profitable portfolio!

Chapter 1:
Introduction to the Stock Market

If you surveyed the general public, you would find that most people have a vague sense of what the stock market is, but few truly understand it. In this book, our goal is to present the ins and outs of the stock market and investing so that you have a rigorous understanding of the markets and how they work. At the same time, we're going to present everything at the level of a beginner. We'll use simple language as much as possible while familiarizing you with the lingo. No math background is required, even though high-level math lies behind many of the tools used by traders. All you need is some basic knowledge and a dose of some common sense. Before I go on, I want to congratulate you. By downloading this book, you have demonstrated that you aren't someone who acts on a whim. You are willing to learn and prepare before throwing all of your money at something. And that is very important. While the stock market offers unlimited opportunities and can help you to build substantial wealth, it's not gambling, nor is it a game or a guarantee. There are real risks, and protecting yourself against the risks is the smart strategy. That is done first by having knowledge.

To get started, we're going to familiarize ourselves with what the stock market actually is and where it came from. We're also going to discuss some of the different ways that people handle investing, from mutual funds to day trading. In this chapter, we will only provide a quick introduction to each investing style; we will use later chapters to explore them in detail. Finally, we'll examine some "what if" scenarios and success stories. No matter which path you choose, I wish you happy investing!

Why Does Wall Street Exist in the First Place?

The answer is painstakingly obvious, but few people on the street could answer this question. Wall Street exists for the same reason that banks exist. Some people have money, or capital, while others have ideas and companies, but they lack the capital they need to build them out and earn a profit. Markets are simply a meeting place to bring all these people together so they can make a mutually beneficial exchange. Markets started out small and direct, with people meeting face to face. Times have changed, and now markets have grown into the modern versions we see today, large and often completely automated with computer-directed trades. But at the lowest levels, the fundamentals are the same as they were hundreds of years ago as are the reasons the markets exist.



In a capitalist society, many people earn more money than they need to satisfy their basic wants. And its human nature to want more of what you have, and those of us who are forward thinking like to plan for the future when we may not be able to work because of old age or disability. So, in order to grow their own capital and invest in the future people with the money available to do so are interested in investing it in order to see a return. That return can be long-term to build their wealth and secure their future, or it could be short-term to earn a profit.

People who create ideas for new products or start businesses, on the other hand, desperately need the money. They are willing to pay others that have it in return for the ability to use the capital in their

business. As we will see, there are different ways that this arrangement can be accomplished.

A quick review of the history of finance

The stock market didn't appear out of thin air, and there hasn't always been a stock market. So where did it come from?

The ideas of finance and investing have slowly developed over the centuries. We could go back all the way to ancient times and investigate the invention of money and the earliest hints of trading, but modern finance actually began developing during the Middle Ages in Europe. The impetus for this development came mainly from the many trade fairs that began popping up across the continent during the early Middle Ages. The first trade fairs began developing around the year 1000 AD and thereafter.

In those days people had to have direct personal contact in order to trade goods. So, a purveyor of spices or fabrics had to meet other merchants or prospective customers in person in order to sell the goods. One problem people had in the middle ages was that travel was relatively dangerous and took a long time. You could either trade locally or spend a great deal of time traveling (and risking both your personal safety and the theft of your wares), and neither option was that appealing. The advent of the trade fairs was a complete game changer. People could gather at major trade fairs and exchange their goods, eliminating the problems cited using the other ways of reaching customers.

Other things that stifled trade at the time were high rates of taxation and border duties. However, the powers that be allowed merchants to trade at the fairs while being exempt to most of the fees that were around at the time. Places that had the best deals ended up seeing the most economic growth and development. This was a large boost to the development and popularity of the trade fairs.

The city of Antwerp in Belgium became a free trade zone. Many merchants relocated there permanently, which altered the course of history for the city, and for finance in general. We can see the earliest glimmerings of Wall Street in these developments.

One of the most interesting developments that occurred with the

trade fairs were merchants that traded in money itself. With merchants possibly joining the fairs from multiple kingdoms or nations, the currency exchange was necessary. Thus, the first Forex markets were born. In addition, money merchants also provided loans.

Later in the book, we will closely examine the notion of a bond, which is essentially a loan of capital in exchange for interest. The idea of a municipal bond, that is a bond sold by a local or city government, was developed in Italy in the 1200s-1600s. Buyers of the bond would receive interest payments from the government entity in exchange for the principal loaned for the bond. Early bonds were perpetual, so you would essentially give your money away in exchange for an endless stream of interest payments (endless that is, until you passed away). In later centuries the idea of a perpetual bond was replaced by a bond with a maturity date, that is the principal would be returned at an agreed upon date in the future ending the bond contract. Other developments that occurred during the middle ages included the concept of an annuity or a perpetual fixed payment. We will discuss annuities later in the book.

The idea of selling stock in a company arose during the age of exploration in Europe. For the first time, companies began to grow so large and so rapidly that they could not be financed without seeking access to public capital. We call this type of investing equity investing, to distinguish it from bonds. Equity means that you own a share of the company. The purpose of equity investing is to make a profit, or capital gain (literally to gain more capital than you originally had). The first instance of equity financing was the creation of the Dutch East India company. You could buy a stake in this company (stock) in exchange for a share of the companies' profits.

Soon after this concept was developed, human nature took over. What are you going to do when you own a profitable object? Some people will hold it hoping to enjoy the long-term fruits of the company, but others are going to sell their share, hoping to make an immediate profit. Thus, the first stock markets were born, in the city of Amsterdam.

It's not a coincidence that the New York Stock Exchange started on

Wall Street, a location that was once owned by the Dutch. However, that didn't happen until the late 19th century. Now that we know where the stock market comes from, we can start discussing what we need to know about it in order to invest.

Types of Investing and Definitions

The modern world of stock markets has been in place for quite some time. Although some of the details have changed and the methods of trading have been advanced through the use of technology, the basic concepts are the same as they were when people were buying and selling shares in the Dutch East India company. We will explore the main ways you can invest your money in future chapters of the book, but in this introduction, we are going to list them here with some introductory comments.

Stocks

You can buy a share of ownership in a company by purchasing shares of stock. On the stock market, stocks are often distinguished in different ways, such as how old the company is, how large the company is, and its profitability. Investors can use stocks for different investment goals based on the company's performance and growth. For example, you might want stability with long term, sustainable growth, or you may opt for rapid, short-term growth.

Publicly Traded Company

When you think of the stock market, you're thinking of a publicly traded company. And that is the focus of this book. A publicly traded company is one that sells shares of stock in the company on a public exchange, like the New York Stock Exchange or NASDAQ, which is a stock exchange developed for high-tech companies. The ownership of a publicly traded company is spread out among members of the general public through the sale of shares of its stock. The shares can be freely traded on a stock exchange. Public trading of stock is heavily regulated, in the United States, this is done by the Securities and Exchange Commission.

In order to buy or sell shares of stock, you have to go through a broker (or brokerage) which is a company that buys and sells the stock on the stock market on your behalf (usually for a fee called a commission). Some people buy stock to invest in the company,

which means you are hoping to make a capital gain on the long-term growth prospects of the company. Investment is also attempting to take advantage of the long-term growth of the economy at large. Over time the stock market grows in size, with individual stocks gaining a lot of value as the years go by. The market trends with the economy, and so it also follows its ups and downs. As we will see later, the downturns aren't really that relevant for long-term investors. Many people waste their energy panicking over recessions and the short-term stock market downturns that accompany them. These are actually buying opportunities.

Other people who buy and sell stock are more accurately described as traders, that is they hope to buy and sell stocks over a short time period in order to realize a profit. When you are a trader, you're not an investor but rather using the stock market as a basis for your own for-profit business. Nonetheless, even if you aren't going to become a trader, you can learn a lot by educating yourself about the metrics they use to determine, buy and sell signals for stocks.

Brokerage

As we mentioned earlier, a brokerage is a company that buys and sells stocks on your behalf. A member of the general public doesn't go to the stock exchange and directly buy stocks, you use the brokerage to do it for you. In exchange for this service, most charge a commission. You have probably heard the names of many brokerages such as Charles Schwab. In today's world, you can buy and sell stocks online or even with smartphone apps. Some newer brokerages that have come of age in the past 20 years from changing technology include eTrade, Tasty Trade, and Robinhood.

Liquidity

The term liquidity refers to how quickly you can turn an investment into cash. So, money itself is highly liquid. It is cash! Some given investment X might be more liquid than Y if you can sell X for cash immediately while it might take a long time to sell Y and get the money.

Dividend

A dividend is a cash payment made by a company to people who

own shares of stocks in the company. Most dividends are paid out on a quarterly basis. Dividends are paid out of profits made by the company. Not all stocks pay dividends. They can be a source of regular income if you buy large amounts of shares, but you have to be aware of what companies pay dividends and which ones don't if that is part of your strategy.

Penny Stocks and Over the Counter Trading

A penny stock is what the name implies –it's a stock that is trading for less than five dollars per share (traditionally less than a dollar, thus the term penny – but inflation has changed the relative definition which is set by the SEC). Trading in penny stocks is highly speculative. When we say the investment is speculative, that means you're usually investing on a gamble that the price of the instrument will increase in the future and that there is a high risk of loss. It's not surprising that penny stocks are speculative; they are priced low for a reason. These tend to be small companies. Some even trade on the major stock exchanges. Sometimes, companies with penny stocks may be a "hidden gem." For example, the company may be in the development stage of a new product, and so people might be drawn to invest in penny stocks hoping the share price will skyrocket when the product is released. It is often difficult to find buyers of penny stocks, so they are considered illiquid.

Most penny stocks trade "over the counter." That means they are not traded on a stock exchange. Trades are made directly between the buyer and the seller in an unsupervised manner or through dealers. Prices of penny stocks are highly volatile, meaning the price per share fluctuates wildly. That is why many speculators buy penny stocks; they hope to profit from the volatility. That is easier said than done for most, however, since it may be difficult to find a buyer when the price goes up (in contrast finding a buyer on a stock exchange is practically automatic).

Historically they were traded with pink pieces of paper, so they are also known as "pink sheets." In short, this is a high-risk activity and not recommended if your goal is an investment and long-term growth.

Initial Public Offering (IPO)

An initial public offering is when a growing company offers shares to the general public on the major stock exchanges for the first time. While they can often be opportunities to “get in on the ground floor” in many cases, the IPO doesn’t work out the way people expected, and the stock ends up languishing.

Investment Bank

An example of an investment bank is Goldman-Sachs. Investment banks take part in large financial transactions and can do so with private companies or government securities. They serve as the intermediary between a company that is entering the stock market for the first time with an IPO, and the general public. A law passed during the great depression, Glass-Steagall, used to separate investment banks from ordinary commercial banks that engaged in typical banking activities like maintaining checking and savings accounts and offering loans. However, during the Clinton administration, it was repealed, and today, banks can assume both roles. An example of that type of bank is Bank of America. Some people believe that the repeal of the Glass-Steagal act helped create the 2008 financial crisis.

Bonds

A bond is a loan, but you play the role of the bank and are the one who lends the money. You led your money by purchasing a bond. You can buy bonds from private corporations, small local and city governments, state governments, and even the U.S. government. The money you lend is called the principal, and you are paid interest in exchange for buying the bond, until the maturity date. Bonds last for a certain time period and expire on the maturity date when your principal is returned. Bonds are traded in secondary markets, and many people are bond traders hoping to profit on the fluctuating prices of bonds. The price of a bond changes because of the interest rates paid on bonds changes. We will explore how this occurs and why as we progress through the book. In a future chapter, we will explore ways that a small investor can invest in bonds.

Funds

A fund is a pool of money used to buy shares of stock or other

financial instruments. There are two main types of funds, mutual funds, and exchange-traded funds. You can invest indirectly by purchasing shares of the funds. For example, a fund could invest in all the companies that make up the Dow Jones Industrial Average. Rather than trying to buy all those stocks yourself, and having to maintain them actively, you could buy shares in the fund. Doing so would allow you to grow your investment based on the performance of the Dow. The value of the funds themselves fluctuates and can be used as an investment or to realize profits. Mutual funds and exchange-traded funds have a lot of similarities, but also some very important differences. Mutual funds are closely "managed," and fees are charged as a result. Exchange traded funds are loosely managed and trade as shares of stock. We will be talking about funds in detail later in the book.

Retirement accounts

Most people are in the markets via retirement accounts. These are specialized accounts designed by Congress in order to encourage people to save money for retirement. The most common type of retirement account is called a 401k and is offered by employers, who will match investment funds that you direct to the account out of your paycheck. Typically, people don't play much of an active role in managing them. You can also create an individual retirement account or IRA. There are specific rules used by the IRS that govern retirement accounts, and the amount of money you can put in an IRA every year is strictly regulated, so that really isn't in the scope of this book, which is about directly managed to invest.

Investment success stories and market gurus

Investing in the stock market, if done correctly, can yield high profits. This can happen across a wide variety of time scales. For example, if you had invested $10,000 in Amazon in 1997, today it would be worth $1 million. Of course, we are benefiting from hindsight, at least to a degree. Nobody knew how dominant Amazon would become in 1997, but it was clear that Amazon was going to be a disruptor. It also shows what relatively small investments can achieve given enough time and growth.

Let's look at some specific examples.

Julie Rains turned $6,000 into $35,000 over a two-year period, purchasing shares of stock in Nvidia.

Anne Scheiber opened a $5,000 investing account with Merryl Lynch. By 1995 when she passed away, that account was worth $22 million.

While his path isn't advisable to follow because of its high risk, Tim Grittani turned a $1,500 investment into $128,000 by trading penny stocks.

Bob Brinker

For 34 years, Bob Brinker graced the airwaves with a radio talk show about investing. Although Bob has retired from his radio show, you can still visit his website and learn about his investment strategies. Brinker emphasizes long term investing with market timing and dollar cost averaging. He has developed three winning stock portfolios that you can follow in order to reach your investment goals. You can subscribe to his investment newsletter at http://www.bobbrinker.com

Tasty Trade

Beginning investors can learn a lot by following the podcasts from Tasty Trade. You will learn more about stock trading, day trading, options trading, and more than you will from most people. If you want to manage your own stock market investing, then tasty trade is the place to visit. The company is associated with a broker named Tasty Works. You can also use them as a broker, and they have the ability to do practice trading.

https://www.tastytrade.com/tt/shows/ryan-beef/

https://www.tastytrade.com/tt/learn/

Ric Edelman

Ric Edelman is another financial advisor who ventured onto the radio, he has a weekly radio show that airs on Saturday evenings in most markets. Edelman is well known as a very successful investor. He also runs an active investment firm. Ric Edelman really knows what he's doing, but keep in mind that he is motivated to win clients for his investment firm. You can get more info about that here:

https://www.edelmanfinancialengines.com/

Jeremy Siegel

Jeremy Siegal is a professor of Finance at the famed Wharton Business School. He is an advocate of investing in stocks. You can read his opinions on his website, and he often appears on the financial network CNBC.

https://fnce.wharton.upenn.edu/profile/siegel/

Squak Box

This is a daily TV program that runs in the mornings on CNBC. It's a famous stop for many business titans. Market conditions and predictions are frequently discussed.

Jim Cramer

Jim Cramer and his show "mad money" is one of the most famous investors in the minds of the public.

Chapter 2:
Choosing a Brokerage

These days, selecting a brokerage is easier than ever, and at the same time more difficult than ever. What do we mean by this? Brokers are all around. You can find multiple brokerages on the internet, including many old stalwarts like Charles Schwab, Fidelity Investments, and Merrill Lynch (which has since been bought by Bank of America, now known as Merrill Edge for self-directed trading). TD Ameritrade has been in business since 1971, and E*Trade, which seems very much a part of the internet boom, was actually founded in 1981.

More recent entries into the world of stockbrokers include Tasty Trade and Robinhood. Robinhood is unique in that it's entirely based on a mobile app, and it offers commission-free trades.

There are many others, and frankly, it's impossible to list them all and all the alternatives. Ease of use can be an issue as well, and Robinhood probably takes the cake with that if you are comfortable using a mobile app to execute your trades (many others offer the ability to trade with apps as well, including tasty works).

Minimum Account Size

The first factor you might consider when just starting out is how much capital, if any, does the broker require you to have in order to open an account. Some might have a minimum amount of cash that you must put in to open an account like $1,000. Some brokers don’t require any cash on hand at all to open an account, but of course, in order to actually buy any stocks, you are going to need to deposit money in your account. Typically, online brokers will have lower minimums than older, more established brokers. For example, Interactive Brokers, Tasty Works, and Robinhood have no minimum requirements.

Withdrawal Fees

Many of the considerations when you select a broker are going to depend on what type of trader or investor you intend to be. If you are looking to make short term trades that seek to profit in cash from the trades, then you are more than likely going to want to opt for a firm that has the lowest fees. On the other hand, if you are a

long term buy and hold investor, then fees and commissions aren't going to bother you as much. With this in mind, be aware that some brokers may have withdrawal fees. If you plan on pulling a lot of cash out of your account that might eat into your profits.

Commissions

Day traders, swing traders and options traders might have concerns about commissions because you're going to be trading frequently and high commissions can eat into your profits. These days low commission brokers are available and you can even try Robinhood for zero commissions. In contrast, TD Ameritrade is known for having high commissions. Of course, competition from no commission firms is forcing some of the others to offer deals; for example, Charles Schwab is offering no-commission trades on many exchange-traded funds.

Analysis Tools

The more involved you are in an active trading life, the more analysis tools you are going to want to have available at your fingertips. Many companies offer a full suite of analysis tools, and it can be helpful to have them right on the screen when you are looking to make a buy or sell decision. Of course, you can get many analysis tools for free such as on Yahoo finance, and use them in conjunction with whatever broker you prefer for other reasons. One drawback of Robinhood is that it's got a pretty skeletal interface and although it's very easy to use to place your orders, it's lacking when it comes to analysis tools.

Margin Accounts

A margin account allows you to borrow from the broker in order to make a trade. When you have a margin account, you can borrow cash from the broker and use it to buy stocks or options, and other financial instruments. If you are looking to open a margin account, you will have to see what the requirements are for each broker you are interested in to determine whether they are a good fit. In order to open a margin account, the broker may require you to deposit more money. The amount of cash required to deposit to open a margin account will vary by broker.

Watch out for hidden fees

Be careful with other hidden fees that may not be so obvious as a withdrawal fee or commission.

Broker List

Below you will find a list of some of the most popular brokers:
Vanguard: https://investor.vanguard.com/home/
Tasty Works: https://tastyworks.com/
Robinhood: https://www.robinhood.com (to use, see app store)
Interactive Brokers: https://www.interactivebrokers.com/en/home.php
E*Trade: https://us.etrade.com/
Ally Bank: https://www.ally.com/invest/self-directed-trading/
Merrill Edge: https://www.merrilledge.com
Fidelity Investments: https://www.fidelity.com/
Charles Schwab: https://www.schwab.com/

Chapter 3:
Investing in Stocks

In this chapter, we are going to go over the basic concepts with regard to self-managed stock investing. In order to do it successfully, you'll have to be familiar with a lot of jargon and data that is used to evaluate the health of a company.

What are stocks

Let's be completely clear about what stocks are. When you buy a "share" of stock, you are buying a share in the ownership of the company. When you do this with your brothers' small business, you might end up owning a significant fraction of it like 20%. But when you are doing this with a publicly traded company, for most people you are buying a tiny stake in the company. Nonetheless, the stock is a financial instrument which represents an ownership share in the company. Theoretically at least, it also represents a claim on the company's profits (more about this later) and on its assets (should the company go bankrupt). Although most people aren't aware of it, there are two types of stock:

- Common Stock: This is what most people think of when you say "stock" and "stock market." A common stock gives you an ownership stake in the company, and if it pays dividends, you get dividend payments. You also get shareholder voting rights. That's for real, but it's up to you to exercise that right if they offer it.
- Preferred Stock: This is a less common type of stock that offers a different set of rights. One of the main differences is that preferred stockholders get priority claim on assets of the company if it declares bankruptcy. Preferred stock can also offer a dividend payment. We won't be discussing it because most ordinary investors are not buying preferred stock.

Aligning buying choices with your goals

The first thing you should do before investing in the stock market is to sit down and figure out what your goals are when it comes to investing. Everyone has their own goals, but here are some common themes:

- Build up a nest egg for retirement.
- Build enough wealth and passive income that you can quit work early or basically do what you want (live life on passive income).
- Make midterm (3-5 year) profits off the stock market.
- Make money now. So, you're looking to buy and sell stocks to get cash this year.

The first thing that we'll note about this is that if you are looking to make money now, then that means you're looking to be a trader or speculator rather than an investor. There are multiple routes to do this, but the main ones are day trading, swing trading, and options trading. We will explore these approaches in chapter 4. Keep in mind that there is a trade-off of risk and reward, the more you want quicker rewards from the stock market, generally speaking, the higher the risk, although the risks with options and swing trading can be mitigated.

If you are hoping to make midterm profits, then you are going to be looking at building a more aggressive portfolio. For those looking to build wealth and passive income, you may be looking at investing in stocks that pay dividends, investing in bonds, or using your stock holdings to generate income by selling options. We will discuss all of these approaches as we go on.

The last goal, building a nest egg for retirement, is a popular way that people look at stocks. In this case, you're looking for solid buys and using a "buy and hold" strategy, so that you build up a significant portfolio by the time you retire that you can slowly draw on at that time for income without having to keep working. We will discuss many of the strategies that can be used for this type of investing in chapter 5.

Aggressive vs. Conservative Investing

No matter what your strategy is outside of being a trader, you can also look at investing from another angle, which is aggressive vs. conservative approaches. And actually, there are two ways to look at this. The first is dividing your investments between stocks and bonds/money in a way that reflects whether or not you are after aggressive growth or trying to protect our capital. By money, we mean a wider array of products such as money market funds, CDs,

etc. With bonds, your principal is (at least in theory) protected. The expectation is that under most circumstances, the stock market is higher risk but will grow your capital at a much higher rate than other types of investments. Of course, sometimes there are unusual circumstances, like the mid-1970s in the United States when the stock market was languishing and interest rates were sky-high. But most of the time, that isn't the situation.

So, if you are conservative, that is you don't want much risk to your capital, then you are going to put more money in proportion towards bonds, money market funds, and CDs that protect your principal, and a lower relative fraction toward the stock market. Financial advisors recommend that people do certain percentages based on their age, so the closer you get to retirement, the more conservative you should get with your investments. That way, you can protect your principal moving into your retirement years. The theory here is that if there is a significant stock market crash, your certain items in your portfolio go belly up, you would need time to recover from the losses. Younger people have time to do so, while those nearing retirement or in retirement don't have time.

The way that you distribute your investments among different types of securities for these reasons is referred to as asset allocation.

Financial advisors have a simple rule of thumb they use in order to suggest what type of asset allocation that you use. You take your age and subtract from 100, and then you put that proportion into stocks. So, if you are 45 years old, 100-45 =55, so you would invest 55% of your money in stocks and 45% in bonds and other more conservative investments.

In recent decades, they have gotten less conservative in asset allocation recommendations. Some advisors use 110, and there are others who even use 120. So, if we were using 120 and you were 45 years old, the proportion of your investment capital that should be in the stock market should be 120-45 = 75%.

The reason that financial advisors have become more relaxed about this is people are living longer and healthier lives, and many people now work past the age of 65.

Midcap, Smallcap, Largecap

Another way that you can determine the relative risk of your portfolio is by what types of companies you invest in. The first main characteristics that you can consider our market capitalization. A rule of thumb (that doesn't always apply) is that larger market capitalization means more stability and less growth, while less market capitalization means less stability but more potential for growth. Obviously, on average, smaller companies have more potential for growth, and some of them are going to grow by massive amounts and become tomorrows blue-chip companies. Just 15 years ago, Facebook was nowhere to be seen, and Amazon and Google were much smaller in comparison to what they are today. However, you can see that this is no more than a rule of thumb, as Amazon and Google, for example, are very large corporations now and yet still capable of explosive growth. Apple also saw remarkable growth over the past decade, even though it was relatively older.

It's pretty difficult to know what companies are going to grow from small cap to blue chip if you picked Amazon 20 years ago well then you were pretty lucky. Most of us don't have a crystal ball. However, as we'll see, you can use exchange-traded funds to get a basket of stocks instead of trying to pick winners and losers.

To calculate market capitalization, you multiply the total number of shares by the price per share. Let's imagine a fictitious company. If they are trading at $100 a share and they have 2,561,780 shares, then the market capitalization is given by:

$100 x 2,561,780 = $256,178,000

So, it's easy to calculate, and even better you can probably simply look up the market capitalization of any company. What category the company falls in is defined in the following way:

- Nanocap ($50 million or less): These are small companies that could be very high-risk investments, but also with a huge amount of potential for growth. You would need to do a lot of research before investing in a company this size, and should probably limit your investment since it might go bankrupt fairly easily.
- Microcap (Above $50 million but under $250 million): Less risky than nanocap stocks, but still pretty risky. On

the other hand, lots of potential for growth, and looking a little more stable.

- Smallcap (Above $250 million, but below $1 billion) These are high-growth potential stocks for growing companies that have become more stable than the microcaps. Still a lot of risks, however. You can invest in many smallcap funds so that you're not betting on one company.
- Midcap ($1 billion to $10 billion): Now we are getting into a good "mid-range" area, that gives you reduced risk that still has some growth potential. Of course, the growth potential may depend on what market the company is in. The reason the company is midcap may be its industry.
- Largecap ($10 billion to $50 billion): If you are conservative investor, then you're going to be investing most of your funds in largecap companies. This is the old "blue-chip" category.
- Ultracap (Market capitalization greater than $50 billion): Rather than extending the largecap category, those who control such things invented an entirely new category for the Amazon's and Apple's of the world.

A financial advisor will typically suggest putting more capital into midcap, largecap, and ultracap companies if you are a more conservative investor, and less capital into smallcap and the other smaller companies. It is the general perception that the largecap companies are stronger companies that can weather downturns in their industry and recessions. It's also believed that large, older companies are more stable.

However, if the 2008 financial crash taught you anything, one lesson you might take from it is that this isn't always true. Many companies got into big trouble in the 2008 financial crisis, and some of them were very well-established firms. Consider that GM, which has been a "blue chip" company for decades, had to be bailed out by the government. Bear Sterns, an investment bank, literally went under overnight despite being more than 100 years old. Its stock dropped by more than $100 a share over a short time period. Other large companies like Bank of America needed to be financially propped up.

So, while the advice given is generally true, it's not always true. If you are looking to run a self-directed investing account, you are going to have to spend a lot of time studying and decide for yourself what is high risk and what isn't.

One key strategy that can always help protect your capital is diversification. That doesn't just mean investing in more than one stock; it can also mean mixing things up among largecap, smallcap, etc. That way, you can take advantage of some of the growth potentials without risking everything in one area.

Volatility and Beta

Now let's start looking at some markers that you can look at in order to evaluate whether an individual stock is something you want to invest in. The concept of volatility is based in common sense. If you see a stock price swinging up and down rapidly over a short time period, to relatively high and low values, then it's highly volatile.

All stock prices move up and down a lot, that's why stock charts are choppy looking. But one that swings up and down with smaller magnitudes in price changes and does it at a slower pace, is less volatile.

But you don't have to eyeball a chart and try to guess. Instead, you should look up a quantity for each stock called Beta. This is a measure of the volatility of the stock as compared to the entire stock market as a whole. What Beta tells you is if the stock is more volatile than the stock market as a whole, or less volatile than the stock market as a whole. A stock with higher volatility is going to have a Beta greater than 1. A stock with less volatility will have a Beta less than 1. If a stock had a Beta of 1.75, that would mean its volatility was 75% higher than the market average. If it was 0.15, then it would be only 15% as volatile as the market. Let's look at a few examples (just jump on Yahoo Finance to look at your own, note they may be subject to change):

- Netflix: 1.49
- Tesla: - 0.39
- Apple: 0.89
- Amazon: 1.74

- Ford Motor Company: 0.91

Notice that Beta for Tesla is negative. What this means is that the stock has been moving opposite to the market as a whole. So, when the stock market goes up, Telsa tends to go down, and when the stock market goes down, Tesla tends to go up. The magnitude of Beta for Tesla is 0.39, so it's less than 1. That tells us even though it got contrarian movement, it's less volatile than the market as a whole.

Netflix meanwhile has a positive Beta, meaning it moves up and down with the overall market (at least right now). It's 1.49, so it's 49% more volatile than the market average.

PE Ratio

This is a price to earnings ratio. It gives you a measure of how the stock is priced relative to the actual earnings of the company. If a stock has an unusually high PE Ratio, that means its overpriced. In the actual formula, we use earnings per share or EPS. So, if a company earned $500, and it had 100 shares of stock, its earnings per share would be $5. You don't have to worry about doing the calculations, sites with stock market data like Yahoo Finance have all these items listed for you. In any case, you can look at the formula one time so that you understand what you are looking at:

PE Ratio = share market price/earnings per share

So, if the share price for our hypothetical company was $15, then the PE ratio would be:

PE = $15/$5 = 3

Suppose that another company with 100 shares also earned $500, so has the same EPS of $5. But say its trading at $10. Then:

PE = $10/$5 = 2

Since it has everything else the same as the first company but the PE is lower, it's a better buy. So, the lesson to take home about PE is that a high PE indicates the stock is overpriced, while a low PE indicates the stock is a good buy – the company has the growth potential that hasn't yet been priced into the market shares of the stock. So, using our example, we'd expect the price of the second

company's stock to rise from $10 to say $13, while the overpriced company might see its shares scale back in price to the same value.

Of course, in the real world, life isn't this simple, but its one metric you can use to find stocks that are good buys. In the real world, all things are never equal. On company that has a high PE might be there because although both companies have had similar earnings up to this point, that company may be releasing a hot new product soon that is going to change the world. So, you have to take it in context of other information.

Here are the PE ratios for the companies we looked at in the last section, for volatility:

- Netflix: 126.71
- Tesla: N/A
- Apple: 14.99
- Amazon: 76.66
- Ford Motor Company: 12.59

Tesla isn't making profits, so it doesn't have a PE ratio. Of course, people still invest because they believe in the product. Amazon and Netflix have pretty far out PE ratios, which could be a danger signal, but it also reveals investors expectations that these companies still have massive growth and profit potential. Apple has (at least for now) run its course with the iPhone, so its PE ratio is pretty modest by comparison, on par with that of Ford Motor Company.

You will have to actually learn about the company, what its product plans are and projected growth in order to make rational decisions about PE and EPS. Don't just go with the numbers.

Earnings per share are usually given on stock market sites as EPS right below PE.

Price to Book Ratio

Price to book ratio is denoted P/B. In order to calculate it, you need to know the book value of the company's assets and liabilities. So, we have:

Book value = Book value of assets – assets of liabilities

Price to book is then defined as:

P/B = Market capitalization/Book Value

If P/B is less than 1, it's considered low. However, that by itself might not be meaningful. It can indicate that the book value is overstated. Generally, a low P/B is probably a bad investment. It generally indicates that the company is not doing very well.

However, no rules are set in stone. You have to look at other factors that may be in play. For example, the company may be getting in shape to turn around. It might have spectacular products that haven't quite been realized (think Telsa), or it could have a new management team that can reverse the fortunes of the company (think Apple when Steve Jobs returned).

It's also important to check the P/B for the industry the company is in. Some companies happen to be in a sector that has low P/B values.

Other Data to Look at

Let's review some of the other information that you will find listed with a given stock.

- Previous Close: Share price the most recent time the market closed. Keep in mind that many securities trade after hours (overseas).
- Open: the opening share price on the most recent day of trading.
- Bid: The amount that buyers are willing to pay for a share. These are often displayed as a size. For Apple on today's date, I see the bid as 178.35 x 800. That means the buyer is willing to buy 800 shares for $178.35 a share.
- Ask: The price sellers are asking per share. For Apple on today's date, it's given as 178.48 x 2200. That means sellers want to unload 2200 shares at $178.48. To actually get a sale, you have to have a selling price at the bid or lower. Notice the imbalance in ask size and bid size. Since ask size is larger, this is an indication that (right now) more people are looking to get rid of Apple stock than there are people to buy it.
- Days range: the range from low to high in share price for

that trading day.
- 52-week range: A measure of the range of share price for the past 52 weeks.
- Volume: Number of shares traded today.
- Average volume: Average number of shares traded in a given day.
- Market cap: the market capitalization for the company, total shares x share price.
- Earnings Date: Mark this one on your calendar and read up what people are saying about it beforehand. This is the next date the company will have an earnings call and give their previous quarters results.
- Ex-Dividend Date: The day before the record date, that is when dividends are paid. You have to own the stock before the ex-dividend date to receive the dividend payment. If you buy the stock on the ex-dividend date, the seller still receives the dividend payment.
- Yield: Annual Dividend Per Share/Price per share
- Forward dividend: Estimation of the dividend per share paid for the year as a percentage of the share price.
- 1-year target estimate: Analysts estimates of the future stock price.

Placing orders and Mitigating Risk

There are different ways that you can place an order when buying a share of stock. The basic way to do it is called a market order. A market order basically instructs the broker to buy or sell the stock now, at the current market price. For a sale to actually take place, the price you ask for the shares must be within the bid price of a buyer. Once you hit buy or sell, if it's a market order, then you're going to buy or sell the shares at the market price that is available at that instant. Most trades are market orders. Market orders generally execute very quickly, but if you have an asking price that is too high, it might delay a sale. I've experienced this and found that when I really wanted to get rid of something, I had to cancel the order and place a new one.

A limit order tells the broker to buy the stock at a specific price or higher. If the stock price doesn't reach the specified price, the limit order may not be executed. So, a limit order is a name the price

order, but it won't necessarily execute.

For example, suppose that you want to buy a certain stock that is fluctuating around $100 a share. You can place a limit order to buy the stock if the price hits $99.50. If the price drops and hits $99.50, your order will be executed, and you'll buy the shares. However, if the price jumps to $102 and never comes back down, then your buy order will never be executed.

The concept of a limit order can be used as a way to mitigate risk. So, you can place an order to sell your shares if they drop to a certain level. Using the same example, if the share price dropped to $98 and you had a stop limit order on your shares set at that price, then your shares would automatically be sold.

You can actually set a long-term duration for a limit order, up to three months in length. So, if you are patient and want to wait for a specific price, that may be an option for you.

Most new traders simply use market orders.

Chapter 4:
Day and Swing Trading

Now we are going to look at a short-term strategy used to earn cash in the here and now, rather than investing in companies for long term growth. These strategies take advantage of the short-term changes in the stock price in order to realize profits. There are really three ways you can do this, the other is options trading, but we are leaving that for a chapter of its own since it's a different animal. The two methods we will discuss here are:

- Day Trading: When you day trade, you buy and sell the same security on the same trading day. This is a highly regulated activity. A brokerage will determine that you are a day trader if you execute 4-day trades within any 5-business day period (that makes you a "Pattern Day Trader"). To be a day trader, most brokerages require you to have $25,000 in your account. There are a few firms that will let you day trade with small accounts, but they charge large commissions. As a result, those companies are used by new day traders without much capital to learn, but experienced traders use regular brokerages so that they can avoid the high fees.
- Swing Trading: this is a lower risk strategy. This is simply a buy-low and sell-high strategy that can last any time length you want but up to a maximum of a few months. A swing trader doesn't day trade, so at a minimum, a swing trader will hold an investment overnight. Swing trading is a much lower risk unless the company goes bankrupt or there is a huge recession (and hopefully you are doing your research so that you know what is possible) the stock is probably going to go higher than what you paid for it at some point in the near future. Since its lower risk, swing trading has no capital requirements.

Despite the differences, the techniques used are the same. Day trading is considered a high-risk activity, higher risk than swing trading, and much higher risk than normal stock investing. It's hard to say that swing trading is really that high risk as compared to buying shares of an individual stock for any purpose. If it's not profitable to sell, the swing trader can just hang on to the stock.

Goals and Risks

The goal of day traders and swing traders is to make cash profits. So, you can think of it as a trading business rather than acting as an investor. You are more concerned with the short-term fluctuations in stock price than you are with the long-term prospects of the company. For the day trader, they are looking at profiting off of price fluctuations that happen over the course of hours, minutes, and even seconds. A swing trader is looking to take advantage of price swings in the share price that occur over periods of days, weeks, or even several months.

One risk, especially with day trading, is that emotion will take hold. This can happen with positive and negative emotions. So, you might have too much fear of loss and get out too early, or you might get greedy and not sell when you should because you have dreams of the share price skyrocketing.

Another risk is new traders don't use standard methods of mitigating risk that can minimize loss of capital when your speculations go wrong. In the next section, we will discuss some techniques that can be used to help guard your account against massive losses. One problem is many people simply jump on and start trading without really knowing what is going on. Instead, you should take the time to invest in yourself and take some courses on day trading from professionals. A search online will reveal that there are many different courses available. Many come with stock market simulators that you can practice with the learn the art of day or swing trading.

Potential gains

Most new day traders will probably lose money, at least at first. However, if you've put the time in to study and done some practice, including taking a course, you might be on the way to becoming a successful day trader. Those that are successful can make high annual incomes.

Risk Mitigating Steps

Before we review the techniques used to evaluate moves on the stock market, let's look at some important risk-mitigating steps you must take in order to successfully day trade without losing all your

capital.

Clear Sell Criteria

If you are looking to profit off the rise in a stock price, then have a specific target in mind and sell when it reaches the target. Let's say you buy shares of a given stock at $10 a share, and it starts rising. You set a profit target at $15 a share. When it hits that you sell it and book your profits, and you don't let emotion get the best of you and fret if it does up to $20 a share. A greedy trader or one who gets overly excited might hold the stock too long, hoping it will just keep rising. But then suddenly it might drop back down to even a lower level than what they paid for it. You should have a profit target in mind when you buy your shares and stick to it no matter what happens.

Stop Loss Order

A lot of new traders don't put in stop loss orders. Use the 1% rule (don't risk more than 1% of your total account value on one trade) to set the level for your stop loss order. What a stop loss order does, is it automatically puts a sell order for your shares if the price drops to a certain value or less. So, if you buy shares of stock at $16 a share, you can put a stop loss order at $15. Then if the stock price drops to $15, your shares are automatically sold, limiting your total loss to $1 a share. If it continues dropping to say $7 a share, you can see how you've saved yourself a huge amount of grief.

Putting a daily limit

You can also help protect yourself by putting a daily limit on the amount of capital you're willing to risk each day. So maybe you only allow yourself to buy $3,000 worth of shares (or whatever) so that you're not betting the farm.

Avoid trading on the margin

Using margin trading (borrowing money from the broker) is where a lot of people get themselves into financial trouble. If you don't spend what you don't have, then you can avoid getting in trouble in the first place. Instead of letting yourself get emotional about some supposedly "sure thing", have a steady plan for profits that you earn over the course of time, rather than hoping that you've "found the

big thing" and you're going to possibly get yourself in huge trouble by borrowing a lot of money to realize your dreams, when the odds are solid your predictions will be wrong.

Calculating risk

Let's look at how advisors recommend you calculate your risk. The risk on a single trade should be 1% of the capital in your account. Let's say that shares of a given stock are trading at $100 and you have an account with $50,000. So, 1% of $50,000 is $500. That means the most you can risk is $500, but that doesn't apply to the total amount spent on buying the shares, so you don't buy $500 worth of shares. What it means is that you put a stop loss order to limit your total loss to $500. So, if you put a stop loss order at $99, that is a $1 loss per share, so you could buy 500 shares. So, you could risk your entire $50,0000 account on the trade! But with the stop loss, if the stock starts tanking, you'd automatically sell at $99 a share, so you'd have $49,500 at the end of the day. Suppose it dropped to $75 a share. With the stop-loss order, it would have no impact on you. But if you didn't have the stop loss order, you would have lost $12,500 on the trade.

Candles

When people day or swing trade, they use "technical analysis" in order to estimate future moves of the stock. The only difference between the two trading styles is the time frames over which the analysis is done. A day trader might be looking at 5-minute intervals to determine what trades to make over the next few hours, while a swing trader might be looking over the course of a few weeks for big swings in stock price.

One tool that is used in the analysis is candles. You can see candles on any stock chart by selecting them as a display option, and you can also set the time duration. Candles were actually invented by Japanese rice traders. Markets are universal.

The candles have "wicks" sticking out from them. These indicate the high and low prices for the time period. Candles are red or green in color. A red candle indicates selling off is dominant, while a green color indicates buying is dominant. Or put another way red candle is associated with dropping stock prices, and green candles

are associated with rising stock prices.



The top wick is the high share price for the period. The bottom wick is the low share price for the period. what the period depends on is what you select for the chart options. So, if you are looking at the chart with 5-minute intervals, the high and low prices indicate the high and low prices for each 5-minute interval.

The body is the solid block. If the block is green, then the top of the body is the closing price (time at the end of the time interval), and the bottom of the body is the opening price (price at the start of the time interval). For a red candle, it's the opposite, so the top is the opening price, and the bottom is the closing price. So, a red candle indicates the price dropped for the given time period; a green candle indicates the price rose over the given time period.

Traders use candles to estimate changes in the direction of the stock price. If a candle of one color engulfs the previous candle of the other color, that is its body is much larger in size, that can indicate a price reversal is coming. You can see it in the picture above, there is a red candle with a small body next to a green candle with a very large body, and that large green candle was followed by an increase in the share price. The large green body indicates that over that time interval, a large number of people bought shares of the stock, and increased demand means prices will be bid upwards.

A hammer is a candlestick with a small body and a long wick below it.



A green hammer at the bottom of a downtrend can indicate that stock prices are about to go higher. So that is a buy signal. If the hammer is upside down, it's called an inverted hammer or a shooting star, for a red candlestick. These occur at the tops of uptrends, and that indicates the stock price is about to begin dropping. A shooting star is a sell signal.



Moving Averages

Another tool that is used in the analysis by traders is looking at moving averages. You can set the number of days (periods) over which you want the stock chart to display the moving average. Moving averages reduce the noise normally found in stock charts so that you can view price trends as smooth curves. Traders often look at charts with two moving averages, one a short-term moving average and one a long-term moving average. When the two moving averages cross each other, then movements in the stock price are expected to follow. You can use either simple moving averages, which is just the average of stock prices over a given period, or an exponential moving average, which is more sensitive to recent changes in price. When a short term moving average rises above the long-term moving average, then a rise in stock price is

expected. The opposite occurs when the short term moving average drops below the long-term moving average. In that case, this indicates a coming decline in stock prices.

Support and Resistance

Traders look for signs of support and resistance in stock charts. Support occurs at the bottom of stock prices, while resistance occurs at the top of stock prices. Support is a price level that defines the floor for a given stock. That is the price never seems to drop below that value. Resistance is the ceiling for a given stock. So that price of the stock doesn't rise above that value.

Bollinger Bands

Bollinger bands use the standard deviation for the stock price to set levels of support and resistance for the share price. The upper Bollinger band represents a high price level that the share price is unlikely to exceed. Remember that we are talking about short term time periods here, this is for day trading or swing trading. The lower Bollinger band represents a price below which the stock is unlikely to drop. The width of the bands also gives us an idea of how much variability there is in the stock price. Below is a chart of Amazon with Bollinger bands. It shows that for the past six months, the stock price could not get above $1966.21.



Bollinger bands are dynamic, so always change as the stock price moves. You can see how in recent months the bands for Amazon are much narrower, indicating that the price variability has dropped quite a bit, although if you look at the chart you'll note that the wide bands on the left are almost entirely due to the one decline in price that led up to Christmas eve 2018.

Summary

Day trading and swing trading are not for everyone, but they can be used to generate short term profits. Some people like the analysis

and getting involved in the short term moves of the stock, so taking a very active role in trading. If the idea intrigues you but day trading seems too risky, consider swing trading, which really isn't that risky in comparison, but you should always use stop-loss orders and be ready to take profits when they come rather than holding too long hoping to get more profits. Also, it's possible to mix things up, and you can put some of your capital into long term investments and use other capital to fund some level of swing or day trading. As we will see later, people interested in short term profits in the stock market can also use options trading.

Chapter 5:
Investment Strategies

Now that we have day trading out of the way, we are going to talk about some strategies that long-term investors use. The purpose of these strategies is to help you maximize potential profits that are made over the long term. However, we have to note before we get started that generally speaking, if you are in the stock market over the long term the odds are in your favor no matter what you do if you don't sell your shares. This is a good article that indicates how that would work. The author follows a hypothetical investor named Bob, who invests in the stock market only at stock market peaks. As the article shows, Bob still ends up with a million dollars:

https://awealthofcommonsense.com/2014/02/worlds-worst-market-timer/

That isn't to say that you should follow Bob's lead in your investing habits. Even though Bob ended up making a lot of money, he left a lot of money on the table too. To maximize your returns, you want to use sound investment strategies. But what's interesting is even during the Great Depression, the downturn wasn't forever. In 1933, the stock market increased by 67%. It also saw large gains during many other years of the depression, although it experienced a 33% drop in 1937, which was known as the "depression within the depression" when many of the gains that had been realized from 1933-36 were reversed, although that only lasted for about a year.

Let's look at the top strategies that you can use in order to ensure you do the most you can to come out without losses and that you maximize your returns.

Diversification

One of the most important investment strategies is diversification. It's the old advice, don't put all of your eggs in one basket. Diversification doesn't mean you can't follow your passions. If you have a company that you are really passionate about, by all means, invest in it. But you should limit the amount of capital that you put into any single company. There are not any hard and fast rules about this. You could put a limit of say 10%. So, if you are putting $2,000 a month into your investments, then only $200 can go to

the hot new stock you think is going to increase as the years go by massively.

Remember one thing, that hindsight is 20/20 and far too many "sure things" ended up being duds.

Many financial advisors recommend that you diversify. In a self-directed account where you are picking your own stocks, you should also limit the number of companies that you invest in. The reason is that you need to know and study the companies that you pick. You shouldn't just be investing on a whim. You have to study the industry the company is involved with, the future prospects and estimates of analysts, and what the growth prospects of the company are going forward. Growth doesn't have to be huge; the economy grows with time, so even 'safe' investments are going to be worth a lot more 20 years from now, barring any major unforeseen events.

So, diversity when it comes to a self-directed investment account should take place along several lines. We have already talked about diversification by investing some money in large cap, mid cap, and small cap companies, etc. We've also discussed the way that many financial advisors propose that you protect your capital as you age by moving it more into bonds and other types of "safe" instruments. But we can do more.

Some other diversification strategies include putting some money into index funds as well as investing in specific companies. As we'll see in the chapter on ETFs, there is an endless number of ways that you can utilize ETFs in order to invest.

One way that you'll want to diversify is by investing in different sectors. For example, it would be foolish to put all of your money into social media companies, or by the same token put all of it into oil and gas companies. A good investor will invest in companies from multiple sectors. This will help you weather the ups and downs. When there are downturns in the economy, they are not going to impact every sector in the same way. Some sectors might even do well while the rest of the economy is languishing.

So, let's summarize the wide array of diversification strategies that you can use to help build a solid portfolio:

- Put some of your money in bonds, money market funds, and CDs to protect some of your capital.
- Buy stock in companies of different sizes. By some micro and smallcap stocks to add some growth potential. Buy some mid caps for solid but safer growth potential, and buy some large and ultracap stocks for added protection.
- Buy stock in companies that operate in different sectors. Invest in energy, health, finance, and other sectors.
- Use ETFs to add index funds and other investments to your portfolio.

Dollar Cost Averaging

Another strategy that is advocated by Bob Brinker and others is dollar cost averaging. We linked to an article at the beginning of the chapter where another "Bob" was described who only bought stocks during market peaks, but still ended up with $1.1 million in his account after 40 years. The thing to remember about "Bob" is he probably didn't end up with nearly as much cash as he could have had. The reason is he missed out on all the buy-low opportunities that were coming his way.

Now one thing to keep in mind is that it's virtually impossible to predict the direction of the stock market over a given time period of say a month or three months. One way to deal with this situation is to average out your buying of stocks as time passes. This is called dollar cost averaging. So sometimes you're going to be buying shares when stock prices are declining, and sometimes you're going to be buying shares when they are increasing.

One way you can do this is to invest a fixed amount of money each month without fail, and don't concern yourself with the short-term ups and downs in the market. If you are trying to build wealth over the long run, then the short-term ups and downs are irrelevant. Twenty years from now, is it going to matter if you bought Apple stock when it was $175 a share or $180 share? Spoiler alert: Probably not. What is going to matter is that you bought (say) ten shares of Apple every month without fail, so that after 20 years you owned 2,400 shares.

Someone who used dollar cost averaging would have ended up a lot better off than the "Bob" described in the article, and they might have been able to retire years earlier since our pal Bob had to wait

40 years to get his million dollars.

Growth Stocks

A growth stock is obviously a stock that is from a company that we expect to grow over time. However, when people talk about growth stocks, they are talking about solid, successful companies whose earnings are expected to increase as time goes on. A growth stock will have a high price to earnings ratio. Some examples of stocks that can be considered growth stocks are Amazon and Netflix. Although none of us have a crystal ball, it seems fairly obvious or at least likely that Amazon is not going anywhere, and it's likely to see increasing revenues for the foreseeable future. The same applies to Netflix, which has developed a service model that addicts its customers. Of course, in the world of capitalism, anything can happen, and five, ten, or twenty years from now, these companies might have been blindsided by the rise of more innovative rivals. But that remains to be seen – for now they are solid bets.

Growth stocks are less likely to pay dividends. That's because they are often companies that prefer to reinvest profits into expansion of the company.

The goal of investing in growth stocks is to take advantage of the future capital appreciation that you expect. So, you can buy shares of Netflix now for $360; maybe in five years, they are going to be worth $500 a share or more.

A growth stock should have the following attributes:

- It's a successful company and expecting to have increased earnings in the future.
- The Price to earnings ratio is high.
- The Price to Book ratio is high.
- If you are a dividend investor, you probably won't be investing in growth stocks.

The bottom line with growth stocks, is you are going to want to invest in more growth stocks if capital appreciation is one of your main goals. Of course, you can weight your portfolio, so maybe you only invest 65% or 70% in growth stocks.

Value Stocks

A value stock is a company with solid fundamentals, but lower

stock prices, and the share price will be lower than expected based on earnings and other considerations. Since earnings may be high, but the share price is low, the P/E ratio will be low. Value stocks will also typically have a low price to book ratio. They may pay dividends and will have a high dividend yield.

If you are looking to build an income generating portfolio, value stocks are likely to be a part of your mix. Value investors often look for stocks that pay high dividend yields. A common strategy is to pick the companies that have the highest dividend yields among the companies on the Dow. Typically, an investor will choose 10 companies. They buy stock in these companies at the beginning of the year and hold them all year long. Then the following January they do the exercise again so that they always have investments in the 10 companies with the highest dividend yields on the Dow.

Other income investing strategies

Another income investing strategy that we will discuss later is to write covered call options. This is a way to divide up your shares into 100 share blocks and earn a monthly income of the shares. There is a risk you will have to sell the shares, however, and we will discuss that in the chapter on options.

Investing in bonds is also a solid income strategy when interest rates are high. A bond is similar to making a loan, except you're the lender. So, the borrower (which can be a corporation, a city, a state, a county government, or the U.S. government) will pay you interest. Bonds can also be traded on the bond markets.

Example Growth Portfolio

The main goal of a growth portfolio is to secure long-term growth. This can be done by carefully selecting companies that you believe have such long-term growth potential. If selecting individual companies, you should pick a minimum of 10 companies. You don't want to select too many because remember – you should be studying the companies that you invest in. So, if you bought stock in 30 companies, it might be hard to keep track of and make smart decisions.

Another approach would be to invest in growth-oriented ETFs, and we will discuss that in the next chapter.

A growth portfolio should have some protection in it. You don't want to throw all your money into Amazon, Netflix, Tesla, etc. no matter how good they look right now. There is always a chance that the market will tank and who knows, maybe world war 3 is around the corner.

So, in order to protect yourself, you should also put some money into bonds and a smaller amount into cash investments (those are money market funds, CDs, etc.). Suggested asset allocation for a growth portfolio could be:

- 75% in a diversified portfolio of growth stocks.
- 20% in bonds.
- 5% in cash investments.

Aggressive Growth Portfolio

If you are looking to build an aggressive growth portfolio, you can do it by adding some smaller companies with growth potential to the mix. You can even include international stocks from developing countries, that might have a huge growth potential over the next decade or two but also carry high risk. If you are looking for aggressive growth, you also probably don't want to be putting money into bonds and cash. Here is a suggested aggressive growth portfolio:

- 40% in a diversified portfolio of growth stocks (large companies)
- 20 % in a smallcap fund
- 20% in developing countries stocks
- 10% in a midcap fund
- 10% in micro and nano companies

Value Portfolio

If you are interested in a value portfolio that will have lower growth potential but more income potential through dividend payments, pick companies from the Dow that have high yield dividends.

- Invest 70% in value stocks.
- Invest 30% in bonds.

Please note that these portfolios are merely suggestions and do not constitute financial advice.

How often to buy shares

How often you buy shares to build out your portfolio is up to you and depends strictly on your personal situation and tastes. Of course, the main factor is going to be your access to capital to buy shares. There is no reason obsessing on it but you can buy shares whenever you want to. The organization takes precedence, however, and it's a good idea to schedule regular stock purchases on some kind of calendar. You can do it once a week, once every two weeks, or once a month. It should be at least once a month.

So, if you are using a dollar cost averaging strategy, you are going to buy a few shares of the same securities on a regular basis. For example, if Exxon is in your portfolio, you can buy 2 shares every 2 weeks. That doesn't sound like much but consider that after a year you've got 52 shares, and then after ten years you'd have 520 shares. Of course, if you have more capital to buy more shares, then do so. But you should never invest more than you can afford, only buy more shares when you've paid all your personal bills and other expenses.

Rebalancing

One of the most important concepts when managing your own portfolio is rebalancing. Simply put, this is a way to reallocate your investments to meet a given target allocation. So if you had an investment portfolio where you wanted 55% in high growth stocks, 25% in the S & P 500 through an exchange-traded fund, and 20% in bonds, every so often you would check to see the value of all your investments and see if they continued to meet your goals. Chances are they won't ;)

So, in that case, you'll have to use rebalancing. So, what you do is add up the current value of each investment portion, and then you buy and sell to get the portfolio back to the asset allocation that you want. Selling shares that you need to sell to rebalance is going to give the opportunity to realize some profits.

It is generally recommended that you rebalance once per year. You don't really need to do it more frequently than that.

Chapter 6:
Exchange Traded Funds

Exchange traded funds, or ETFs as they are often called, are a very exciting way to invest in the stock market. There are many advantages to an ETF as opposed to buying individual stocks. You can use exchange-traded funds to track major stock indexes, such as the Dow Jones Industrial Average, the S & P 500, smallcap stocks, midcap stocks, largecap stocks, growth funds, value funds, real estate, gold, stocks in developing markets – you name it, it can be tracked with an ETF.

Essentially exchange-traded funds are like mutual funds, but they trade like stocks. So, you can just buy and sell shares the same way you'd buy and sell shares of Apple or Facebook. Unlike mutual funds, they are not actively managed by a financial guru so the fees are much lower. Also, while mutual funds only trade once a day, exchange-traded funds trade throughout the day like stocks because they are stocks.

ETFs Offer Automatic Diversity

When you invest in ETFs, you can choose between different indexes and sectors, among other things. So, you get automatic diversity because the fund is investing across a wide array of companies on your behalf. One of the most popular ETFs that are out there is SPY, which is a fund that has invested in the companies that make up the S & P 500. Imagine the difficulty you would have investing in all 500 companies, and then having to adjust the portfolio looking to weight the fund to get more money invested into companies that performed better, and then taking companies in and out of your investments as the makeup of the S & P 500 changed. Of course, this would be a complete nightmare. So why not let someone else handle all of that for you? You can just invest in that fund and then let the market do the rest.

There are exchange-traded funds for many different sectors and investment goals. Finding the right ones for your situation will require a bit of research.

The Main Companies offering ETFs

There are many investment firms that offer exchange-traded funds,

but the main ones that you should spend your time looking at include:

- State Street SPDR
- iShares
- Vanguard

While you are going to find that these companies offer funds that cover many of the same sectors and indexes of the markets, you are going to want to go head to head comparisons. Two funds that invest in the Dow Jones Industrial Average are not going to give you the same returns, for example. The reason is that while they are invested in the same companies, the weightings of the investments may be different. So, fund A may invest in companies 1,2,3, & 4 by putting 25% of the fund in each company, but fund B might put 30% in company1, 40% in company 2, 15% in company 3, and 15% in company 4. Why would they do that? They might believe that companies 1 & 2 have much better growth potential.

So how are you going to find out which fund is better? By studying their past performance. Compare returns for different funds against each other and pick the one that you feel is best. Many times, the differences won't be stark. You will also want to have a look at fees associated with each fund, but for those coming from mutual funds you will be pleasantly surprised, the fees associated with exchange-traded funds are negligible.

Use Exchange Traded Funds to invest in … everything

One of the things about exchange-traded funds is that you can put money into virtually anything. This makes them exciting and can offer an opportunity to build a real diversified portfolio but only by using stocks. For example, you can buy shares of VGIT, an exchange-traded fund offered by Vanguard. This fund invests in intermediate-term Treasuries – U.S. government issued bonds. So rather than buying the bonds themselves, you can buy shares in this fund.

GLD is a fund offered by SPDR that invests in gold. So, you can invest in gold, but do it by owning shares of GLD, rather than going out and buying gold itself.

Let's take a look at funds that can help you build a diversified

portfolio that suits your investment goals.

Remember – these are stocks

Although we are mentioning funds offered by different companies, you don't have to go to that company to invest. So, while you could open a Vanguard account, you don't have to. These funds all have stock tickers, you can just log into your brokerage account and simply buy shares in whatever fund you like.

A look at some example funds

For examples of largecap funds, we'll have a look at offerings from Vanguard. Stock ticker VIG is a dividend appreciation fund. It tracks the "Dividend Achievers Select Index" on NASDAQ.

VUG, on the other hand, is a largecap fund that tracks growth stocks. The ten largest holdings in this fund include Microsoft, Apple, Amazon, Alphabet (Google), Facebook, VISA, Mastercard, Home Depot, Boeing, and Comcast. Notice that by investing in this fund, you're automatically exposed to these ten companies while only having to make one investment.

When you look at each fund, you can also look at the weighting the fund has by sector. For example, this Vanguard fund has 34.9% invested in technology, 20% in consumer services, and 13.9% in industrials.

Different funds that cover the same general goal will have different weightings by sector and different companies in their portfolios, although there may be a lot of overlap. These differences will impact the performance of each fund.

VTV is another largecap offering by Vanguard. It is listed as a largecap value fund. The holdings in this fund are quite different, reflecting the different goals of the fund. This time the top 10 holdings are: Berkshire Hathaway, JP Morgan Chase, Johnson & Johnson, Exxon Mobile, Proctor & Gamble, Bank of America, Cisco Systems, Pfizer, and Intel.

VOT is a midcap growth fund managed by Vanguard. The holdings on this fund include Roper Technologies, Red Hat, and Twitter, among others. Vanguard considers it to be in their highest risk category, but if you are looking to add more aggressive growth to

your portfolio, its an option to consider as opposed to making the investments yourself. Vanguard also has a few smallcap funds. You can also invest in microcap ETFs, IWC is a microcap fund offered by iShares.

Tracking index funds is one of the best ways to use ETFs. We've already mentioned SPY, but there are many other stock indexes that you can track to invest in different areas. Some of the other index funds and sectors you can track with ETFs are:

- NASDAQ Composite Index: Mostly technology stocks traded on NASDAQ.
- Wilshire 5000: Designed to track the entire stock market. Not as popular as SPY.
- S & P Midcap 400, Russell MidCap, Wilshire US Midcap: Track midcap companies.
- Russell 2000: Tracks smallcap companies.
- Sector funds: Track energy, healthcare, finance, utilities, etc.
- Emerging markets.
- Real estate.
- Corporate bonds, including junk bonds.
- Precious metals, including gold and silver.

ETFS and Dividends

One question many people have does ETFs pay dividends. The answer is yes, they do. So, if you are looking for a way to build an income investment portfolio based on dividends, exchange-traded funds can be part of that process. Dividends are paid out quarterly. The proportion of dividends you receive will depend on what percentage of the fund you own. So, if you own 0.1% of the fund, you will receive 0.1% of the dividends.

ETFs and Bonds

We will discuss this in the next chapter, but we are going to mention here that you can use ETFs to invest in bonds, but more importantly, you do receive any interest payments from the bonds.

ETFs Make it Easy

One of the nice things about using ETFs to build a diversified

portfolio hitting different market capitalizations, sectors and so forth, is that you can diversify your portfolio without having to study the details on dozens of stocks and companies. Of course, different things appeal to different people; some people actually want to put the time in studying companies and their performance, while others will prefer the hands-off nature of ETFs.

What I like to do is mix it up, so I will invest 50% in individual stocks, and the other 50% of my stock market investing goes to ETFs. There is no reason to be exclusive one way or another unless you really want to.

Chapter 7:
Bonds

Bonds are an interesting financial instrument that has been around for centuries. As we mentioned earlier, they were originally used by local Italian governments to raise funds. In those days, they were perpetual, so you would give your principle to the government and then receive interest payments for life. Maybe they could be thought of as the oldest annuities instead.

Later, bonds were issued with maturity dates as they are today. That is the date when the bond expires and you're supposed to get your money back, and the interest payments stop. A bond that doesn't mature is irredeemable. A bond is redeemed when you turn it in to get your principal back.

Bonds have traditionally been a "safe" investment used by investors to protect their capital. You can also trade bonds on the bond markets, and profit from changes in bond prices that happen when interest rates go up and down. We will be discussing how all this works below.

Bond Basics

Let's get started by talking about the basic concepts behind a bond and the basic characteristics that all bonds have regardless of who or what is issuing the bond. The first thing to know about a bond is that it's a loan that you make to the organization in question that issues the bond. In return for the money (the principal) that you provide to the bond issuer, they will make regular interest payments to you for the life of the bond, although as we will see, there are other ways to make this arrangement. Therefore, when you buy a bond, you are a creditor the same way that a bank is a creditor when they loan someone money to buy a car or to do home improvements.

Since a bond is a loan, it is formally known as debt security. Since bonds can be bought and sold on secondary markets, we say that they are negotiable. Bond prices fluctuate up and down inversely with interest rates. We'll see why below, and we'll also look at some examples of changing bond prices and try to understand why the prices change the way that they do.

Even though you can buy bonds from and hence issue debt to a company, a bond does not entitle you to an ownership stake in the company. It's only a loan to the company, but you have no rights regarding the company unless it goes bankrupt, in which case you'd have a claim on its assets. If a company does go bankrupt, by common law bondholders have priority over those who own stock in being repaid. In the table below, we compare some of the basic properties of stocks and bonds, so that you're familiar with the differences:

Stocks		
Ownership (Equity)		
Perpetual		
Before stockholders, after secured creditors		

Who Issues Bonds

Bonds are issued by many different types of institutions. Corporations issue bonds. The United States government (and other governments) issue bonds. State, country, and city governments also issue bonds. Indeed, some of the most popular bands in the 20th century were municipal bonds, or "munis," which offer a tax shelter. They were often used by the wealthy to park money during eras of high tax rates so that they could avoid paying them.

Definitions

Now, let's familiarize ourselves with some of the important definitions that are associated with bonds. These definitions will help you understand how bond trading operates and help you to buy bonds if you decide you want to do that as a part of your investing strategy.

Par Value/Principal

The par value is the same as the principal. This is also called the nominal value. A bond is issued as a sheet of paper that has a value printed on it, which is the par value. It's also called the face value. So, when a bond sells for the first time, if the par value is $10,000, then you have to pay $10,000 to get the bond. However, it called the nominal value or face value because, on the markets, bond values change. So, if you decide to sell the bond on the secondary

market, you might get more than $10,000 for the bond, or you might get less than $10,000 for the bond depending on what conditions dictate. When the term of the bond comes to an end, you will be paid back the face value. As we will see when we discuss U.S. Treasuries, some bonds work a little bit differently.

Coupon

The word coupon is used because of its historical legacy. The coupon is the interest rate for the bond. In the old days, bonds were actually issued with coupons that you could tear off and take in to receive your interest payment. Interest payments can be made with different frequencies depending on the issuer of the bond, however, the interest payments for most bonds are either paid twice a year or annually.

Clean Price and Dirty Price

The clean price is the price of the bond minus accrued interest. The dirty price of a bond is the price of the bond, including the accrued interest.

Yield

Yield is the return an investor can expect from owning the bond. If you simply buy the bond from the issuer and hold it, then the yield will be just the interest rate or coupon of the bond. Current yield is given by the annual interest payment/price of the bond x 100. Bond prices and yields move opposite one another. So, the higher the yield, the lower the bond price. The higher the bond price, the lower the yield. This will make more sense later.

A more complex calculation that is often considered is yield to maturity. That calculation takes into account the difference in the price that you paid for the bond as compared to its par value, the number of years until maturity, and the interest rate of the bond.

Redeem a Bond

This means to turn it in to receive your principal back, and interest payments cease.

Maturity Date

The date the bond expires, so the date is redeemed.

Callable Bonds

A bond can be called. That means that when the issuing entity calls the bond, it has to be redeemed and essentially the bonds life has come to an end at a date of the issuing entities choosing, prior to the maturity date. That means you get your principal back and interest payments stop.

The Health of Issuing Entity

While the interest rates paid by bonds are influenced by the overall interest rates, they are also influenced by the financial health of the entity that issues the bond. This is the same principle at work that you find when an individual goes for a loan. A person with good credit can get a loan with low interest rates. A person with bad credit has to accept a loan with high interest rates. The same thing happens in the case of bonds. If a company with a checkered history is raising capital by selling bonds, then it must offer high-interest rates. The lowest quality bonds are known as “junk bonds.” Like a loan to a person with a bad credit history, they carry more risk, and there is some risk that you could lose your principal. However, some investors are willing to assume that risk for the high-interest payments.

Zero Coupon Bonds

This is a different kind of bond that pays no interest. Instead of paying regular interest payments, the bond will be sold at a price that is lower than the face value. However, when you redeem the bond, you are paid the face value of the bond. So, for example, suppose you buy a $100 zero coupon bond with a 6% interest rate. You will actually pay $94 for the bond. Then in 12 months when you redeem the bond, you get paid $100.

How Bond Prices Vary

The basic rule for bond trading is that when interest rates rise, bond prices drop. They do so because the higher interest rates will be available by purchasing new bonds, so the old bonds have less appeal. On the other hand, if interest rates drop, bond prices rise. In that case, the older bonds that paid higher interest are more

valuable than the new bonds.

So, let's say that you purchase a $10,000 bond, and the interest rate is 6%. If the interest rate drops to 4%, what is the price of the bond if you try and sell it on the secondary market? In that case, the interest rate dropped, so the bond price is going to rise. The interest payment is $600. To estimate the new bond price, we take the price that would be paying $600 at 4% interest. That would be:

$600/0.04 = $15,000

Now consider an alternative scenario. If the interest rate rises to 7%, then the bond price will drop. It will drop in such a way that the price paid to buy the bond on the secondary market would work out so that $600 is 7% interest. So, the new bond price is:

$600/0.07 = $8,571.43

When the bond reaches maturity, the face value of the bond is returned. So, if you bought the bond on the secondary market for $8,571.43, and you got the $600 interest payments, you'd make a little profit when the bond reached maturity, and you get the $10,000 principal.

Municipal Bonds

Municipal bonds are issued by state and local governments to help fund operations, like building new streets or libraries. Short term municipal bonds have maturity dates 1-3 years from the date of issue, but most municipal bonds are long term, expiring in a decade or more. They have been attractive to wealthy investors because they provide a way to earn long term interest payments. The interest is usually not subject to Federal income tax, so historically they have provided a ready-made tax shelter. When top tax rates were 90%, you could avoid paying them by investing in municipal bonds. There are two types of municipal bonds. General obligation bonds are used for day-to-day operations. They are "backed" by the taxing authority of the government entity that issues the bonds.

Revenue bonds are not backed by the taxing authority of the government, but rather from revenue that might be generated from a given project. For example, if the government in question issues the bonds to help build a new highway, they can collect revenue

using tolls.

You can invest in bonds online by checking out brokers that specialize in bond trading. You can also invest in corporate bonds issued by large companies like Apple and IBM.

United States Treasuries

Perhaps the most famous bands of all are those issued by the federal government. At least until now, these have been considered the safest investments in the world. The debt of the U.S. government keeps rising, and at this point, investors don't seem to be bothered, but at some point, bonds issued by the U.S. government may be less appealing, which would lead to a rise in interest rates paid by the government.

You may have heard about U.S. Savings Bonds. Interest from US savings bonds is tax-free for local and state taxes. They are non-negotiable, meaning that they cannot be traded on secondary markets. Since they are not tradable, the value of the savings bond does not change with time as interest rates change, the way regular bond prices can. Savings bonds are a type of zero-coupon bond, so they do not pay interest payments, and the maturity is 15-30 years. However, you can redeem the bond if you've held it at least 12 months. When you redeem the bond, you are paid the face value plus interest. However, you are penalized if you redeem the bond early, and the final three months of interest will be withheld.

Savings bonds are priced from $25 up to $10,000. To either buy or redeem a US Savings Bond, you go to the Treasury Direct website run by the federal government.

If you are looking for a short-term investment via the United States government, then you can consider Treasury bills. These have terms lasting from a few weeks up to one year. Just like savings bonds, they are zero coupon bonds so you will not receive interest payments. In the case of treasury bills, they are sold at a discount. Then when you redeem the bond, you get paid the full-face value. The difference between the discounted price you bought the bond for and the face value payment is the interest.

A Treasury note is an intermediate-term bond. They have maturity dates that range from 2 years up to 10 years. Unlike savings bonds

and Treasury bills, Treasury Notes pay interest. The interest payments are paid every six months until the maturity date. At that point, you can redeem the bond and receive your principal back.

Finally, there are Treasury bonds. These are long term investments with a maturity date that can be 30 years. They also pay interest every six months. If you live long enough to redeem the bond, you can receive your principal back.

Corporate Bonds

Investors can also look at corporate bonds. They will pay higher interest rates than government issued bonds because they are higher risk. You can buy corporate bonds from a broker, the way you can stocks. The issues at hand in choosing which bonds to buy are similar even though the investments themselves are quite different. So, you will want to take time to review the company's fundamentals before investing in their bond offerings. There may be additional information to consider, such as how good the company is at handling credit. Just like you have a credit rating, bonds are rated as to their quality, which in a nutshell can mean how much risk there is that you'll lose your principal. As we noted earlier, the riskier the debtor, the higher the interest rate. High-risk corporate bonds can pay handsome interest rates and are known as junk bonds.

Buying Bonds Through Funds

You can buy bonds directly, but one of the easiest ways to get in the bond market is to invest using exchange-traded funds or mutual funds. As with stocks, diversification with bonds is just as important. If some company is issuing bonds that have a junk rating, you might fantasize about putting all your money in to get the 9% interest rates they are paying so you can have a nice income without having to work, but if the company goes bankrupt or simply doesn't pay the principal back, well then you've lost some money. You can protect yourself with diversification and buying into a fund that invests in bonds on your behalf is the best and safest way to do that. A bond ETF holds investments in bonds, but they trade like a stock on the stock exchange. Maturity dates won't be your concern, because the managers of the fund take care of the underlying assets on your behalf. One interesting feature of a bond

ETF is that you still receive the interest payments. But even more to the point, you get interested payments each and every single month. Remember that bonds typically pay interest either once every six months or once a year. The good thing is bonds all have their own date when the interest is paid, so when you invest in a fund that contains a large number of bonds, they are distributed throughout the year, so you will get monthly interest payments. This can make investing in bonds via a fund more attractive. You can use bond ETFs and mutual funds to invest in every type of bond, from municipal bonds to corporate bonds and also US government bonds. If you go through an ETF or mutual fund, you can save yourself the headache of having to trade on the bond markets. Your fees will also be much lower.

Chapter 8:
Mutual Funds

A mutual fund is a pooled fund of money from multiple investors that is used to purchase assets on their behalf. Mutual funds invest in many different areas, such as stock market indexes, different sectors, large cap, small cap, etc. You can also find mutual funds that are structured for growth or value and to meet the many different investment goals that people have, such as investing in bonds. In some ways, mutual funds are like exchange-traded funds. One important difference is that mutual funds don't trade on the stock market. Mutual funds are only traded once at the close of each business day.

Benefits of Mutual Funds

Like exchange-traded funds, one of the benefits of mutual funds is that they provide a ready-made way to have diversified investments. This will help to mitigate your investment risk. Mutual funds can be very highly diversified; some may hold hundreds if not thousands of investments in underlying assets. So, you get huge diversity when you invest in a mutual fund, however, remember that you will get the same diversity when you invest in an exchange-traded fund, and there are several advantages to taking that route.

Another advantage of mutual funds is you can find funds that are set up for your investment goals ahead of time. So, for investors that don't want to think about what they are doing, using mutual funds is a conservative approach to investing that is basically a set it and forget it approach.

Minimum Investments

If you are going to invest in an exchange-traded fund, you can buy as little as a single share to get started. This isn't the case with mutual funds. They are going to require a minimum investment. The required minimum investment isn't going to be very large, but will be at least $1,000 and can range as high as $5,000.

Fees

The fees for mutual funds can be relatively high, and besides the way that they are traded, this is one of the biggest arguments against them. A “load fee” is charged every time you buy or “redeem” shares of the fund. You don’t sell shares of a mutual fund, you redeem them, that gives them back to the company that manages the mutual fund. Load fees can be quite large, going as high as 8%. That is huge when you consider the practically nonexistent fees of exchange-traded funds. Moreover, load fees can be complicated. There are front-end load fees charged when you buy the shares, and back-end load fees charged when you redeem shares. Back-end load fees can be variable, depending on how long you held the shares. The longer you hold the shares, the lower the fee. So, they are encouraging you to stay in the fund.

There are also “level-load” fees that are charged once per year.

Actively Managed vs. Passively Managed Funds

Funds can be actively or passively managed. A passively managed fund is typically one that tracks a stock market index like the S & P 500. Passively managed funds, as you might guess, charge lower fees than actively managed funds. The goal of a passively managed fund is to match the return of the index that the fund tracks.

Actively managed funds mean exactly what the name says; they have an active manager or managers that run the investment portfolio. As you might imagine, that costs money. The fund managers will buy and sell assets in the fund in an attempt to beat the average return of the stock market. So, they are doing what you would be doing yourself if you manage your own stock portfolio. Generally speaking, beating the average return of the stock market is not an easy task. However, some research exists showing that actively managed funds often beat the market. That said, they don’t beat it by huge amounts, and the massive fees that mutual funds require can wipe out any gains from having the fund actively managed. Long term studies that have been done actually show that passively managed funds return nearly three times as much as actively managed funds.

Exchange Traded Funds vs. Mutual Funds

If you enjoy dressing up in a suit and going to an office to hand

over your money to pay fees, and then let the professional manage your investment account for the next 30 years, then mutual funds might just be right up your alley. All joking aside, mutual funds are suitable for some people and not suitable for others. If you are the kind of person who has an interest in actively managing your stock investments, then you are probably not going to be someone who is interested in mutual funds.

The bottom line is that in reality, exchange-traded funds basically offer the advantages of mutual funds but without the constraints and extra fees. Mutual funds are a bit of hassle when compared to exchange-traded funds. As we mentioned above, long term studies at best (from the perspective of mutual funds) don't beat passively managed funds, and in fact, 30-year studies have shown much better returns from passively managed funds. Even if we accept that many mutual funds can beat the market, you have to ask yourself if it's worth paying all those extra fees in order to get active management.

With exchange traded funds, you're in complete control. You can trade day to day if you want to, and you don't have to pay any "back end" fees if you want to sell your shares. So, exchange-traded funds offer the diversity, convenience, and ability to invest in many different sectors and types of investments in one package, but they are far more flexible. When you are investing in exchange-traded funds, you are in complete control and don't have to worry about some mutual fund company. But most importantly, you don't have to pay for all the high fees. There are fees associated with exchange-traded funds, but they are trivial. There used to be less difference when commissions were more of an issue, and so you'd be looking at paying the broker a commission for trading an ETF. But for example, you can trade commission free on Robinhood. And outside Robinhood, many brokers are offering commission-free trades on ETFs. So that negates that old argument.

Problems Buying and Selling

Since mutual funds only trade once per day after market close, this can cause issues if you want to buy and sell shares. Suppose it's in the middle of the day and the S & P 500 is really moving. So, you want to buy shares in SPY. It trades like a stock, so you just pull out your smartphone and buy the shares. You see the price right there

when you place your order.

In the same scenario with a mutual fund, if you decide in the middle of the day that you want to buy shares of an S & P 500 mutual fund, you will know what the price was the previous day. However, you can't know what price you're going to pay for the shares if you placed an order at that moment because the fund is not going to trade until after market close. That is a huge disadvantage.

Chapter 9:
Options Trading

In this chapter, we're going to take a look at the exciting world of options.

One option is a contract that is based on some underlying shares of stock. Basically, an option gives you the right to buy or sell shares. There are two types of options contracts called calls and puts based on whether the buyer of the option has the right to buy or sell the shares.

These can be used to make profits based on the short term moves of stock prices. The good thing about options pricing is that options are much cheaper than the shares of stock that they represent. For that reason, if some people are interested in getting into short term trading, options are a good way to do it. So, whereas you would spend tens of thousands of dollars hoping to profit off a rise in stock price doing day trading, you can get into options and only spend a few hundred dollars and gain some profits off the rise in the underlying share price. The ROI for options contracts is much higher than it is for stocks.

Another way that options are very interesting is for income investors. In that case, you're going to want to use your shares of stock together with the options in order to generate income from your shares of stock. As we get into the chapter, we will see how that works.

Two Types of Options- Calls and Puts

So, let's get started by defining the two types of options that there are. They are known as calls and puts. A call gives the buyer the right to buy 100 shares of stock. They don't have to do exercise that right in the real world, and it turns out that in most cases, traders don't actually exercise the rights. Options have a value of their own and people try to make money as options traders, and don't really want to own the stocks.

But let's not worry about that right now- let's just try to understand how these things work. We will get into the details of puts in a minute, but for now, just note that a put option gives the buyer the right to sell 100 shares of the underlying stock.

The first thing you need to know about options is it that they are temporary. Every options contract comes with an expiration date. If the terms of the contract are not exercised by the expiration date, the option simply expires worthless. This can be used to the advantage of income investors who are hoping to earn some regular monthly income off of their shares. You can write a call option and sell it, and there will be some risk that you will have to sell the shares underlying the contract, but the odds are that won't happen, and you can pocket the money you made selling the option.

So obviously if it just involves what we said so far it would be hard to see why options would be worth money. But there are two other important things you need to know about options. The first is when you buy an option, you agree on the price for the sale of the shares of stock at the time the contract was written. So, if I buy an option on January 2 and we agree at that time that the share price is going to be $100 if I exercise my right to buy, but when the option expires three weeks later, and the share price is $120, you still have to sell me those shares for $100.

So that is in part a motivation for people to buy options contracts.

There's another thing that we need to know about options. That is this. Each options contract represents 100 shares of stock. The shares of stock that are represented by the options contract are known in the industry as the underlying. Some people will describe options by saying that when you buy an options contract, you control the underlying shares. And they will note that you're able to control the underlying shares for a fraction of the cost as compared to what it would cost to actually purchase the shares on the market.

That is true as far as it goes. But the extent to which you actually control the shares of stock will depend on how much capital you have access to, in order to carry out the possible options that this contract calls for.

So earlier, we mentioned that a call option gives the buyer the right to buy the shares at a fixed price. The price per share that is agreed-upon in the contract is called the strike price.

So, let's say that we're talking about Amazon stock. It's priced very high. Let's just say for the sake of argument that it's $1800 a share

which is pretty close to the actual value. So, you could buy an option contract for a lot less money. After all, a hundred shares at that price are going to run you $180,000. That is not something to sneeze at.

On the other hand, you could buy an option on Amazon for quite a bit less money - a tiny fraction of what the actual shares cost. Right now, I'm going to look up an option and get a price so we know what we're talking about for real. So, a June 7 option which is a call for $1837.50 (the strike price) is selling at $30.70.

But here's the deal. The price given is per share. So, the total price or should I say the actual price that you need to pay to buy the option is $3070. OK, that's not exactly bus fare, but one thing we can say about it is that it is a lot less than $180,000!

However, if we were talking about actually exercising the option, you would need to have the money to buy the shares at the strike price. So, in other words, to actually exercise the option you need to have $180,000 cash, or you need to be so good with the broker that they will let you buy the shares on margin (that borrows money to buy the shares).

Now we can't say that that's actually an impossibility. You have to ask what is the situation in which you would really exercise the option on a call. Keeping things simple, let's say that the share price of some stock is $100 a share. So, let's say that you buy a call option on the stock with the strike price of $102. Now let's say that the price jumps up to $110. So, you exercise your right, and you buy the shares.

So why would the broker possibly loan you money to buy the shares on margin? Well, the reason might be that you could sell the shares immediately once you got them in possession – you just turn around and sell them on the market for $110 per share.

So, you borrowed at $102 per share from the broker, and then you sell the shares for $110, you pay the broker the $102 per share back. So far then you made a profit on the sale of eight dollars a share.

Now maybe that would work out, or maybe it wouldn't, it would depend on other things such as how much did you pay to buy the

option.

An option for a stock that cost $100 is going to be a lot cheaper than that option we considered for Amazon earlier. So, let's have a look and see how much one of those costs for some real stock. Picking a random example, I looked up American Express, which is trading around $118.37 per share at the time of writing. Looking at options that expire in one week, an $118 call is $1.02. So, it will cost you $102 since the price is for 100 shares.

So, it might be possible for you to make a profit of $100 per share stock under those scenarios that I mentioned of borrowing money to buy the shares. So, if we imagine that we were able to borrow the money, we would make an eight dollar per share profit, and then we would have to deduct the one dollar per share fee that we paid to buy the option in the first place. So, you would still end up making a profit.

But you always have to keep in mind that's not how most options end up. The fact of the matter is the vast majority of options are simply traded back-and-forth on the options markets. Investors are hoping to make profits on the trades, nothing more and nothing less. So, people invest in options, not for the point of actually buying the stock in most cases, instead, they buy options to make money off of trading the options themselves.

Options Pricing

So, to understand how this works you need to know how the pricing of options goes up and down. So, for right now are focused on calls. In this case, what happens is - if the share price goes above the strike price for a call, the general rule is that the call is going to go up in value.

If the strike price is above the share price, and the share price is dropping, in that case, the value of the call option is going to go down.

The price of an option is also affected by the time left until the option expires. More time left, more value. You can buy options that expire at many different dates. Some are weeklies meaning that they expire next week. You can also buy options that expire many weeks into the future or even months into the future, but they are

more expensive. The reason they are more expensive is not only is there a long time before they expire but looking at it another way, there's a lot of time left for the stock to move that could really change the value of the option.

Then the share price is higher than the strike price of a call option, they say it "in the money." When the share price is equal to the strike price, it's "at the money." If the share price is below the strike price for a call option, it's "out of the money."

What you need to remember is the closer the option gets to the expiration date, the more it's price decays. There is a tug of war between the time decay of the price and the share price. So, at the same time if the price of the shares (in the case of a call option) is rising above the strike price, then the price is going to be rising.

For this level of the book, we're not going get into the actual formulas, but there are ways to predict the actual price. But a general rule of thumb you can keep in mind is that a dollar rises in the share price is going to lead to a $100 rise in the value of the option. That's because each share goes up a buck and it's 100 shares for the option.

Be advised this is far from exact, but it's a reasonable rule of thumb to understand what's going on. You can buy a more advanced treatment of focuses only on options to learn what the real formulas are and how they work. Also, if you get online, you can find spreadsheets which will do the calculations for you and the predicted prices are very accurate.

There is a parameter you need to know if you want a more accurate estimate of price changes, which is called Delta. Delta is something you can read on the stock info about the option provided on sites like Yahoo Finance. What it tells you are is a more accurate estimate of what the change in the option price is going to be for every dollar change in the share price.

So, if delta is .6, and the share price rises by one dollar, then the price of the option on a per share basis is going to raise $.60. That means the total price of the option would rise by $60. The value of the option that comes from the underlying stock is known as the intrinsic value.

The value of the option that comes from time left to expiration is called extrinsic value. At a certain point that will totally lose value. Compare two options, an option that has a longer time to expiration but the same strike price as another option will be worth more money.

Let's look at that for American Express. I quoted you an option that expires in a week for $118 and it was $1.02 per share. But if I took three weeks out an option with the same strike price costs twice as much money. The listed price is $2.05 per share. That reflects the fact that with three weeks left until expiration, that option will be around long enough to take advantage of any volatility in the price of American Express stock before it reaches the expiration date.

But of course, there's a balance - at some point, the time value is going to be decaying enough that it takes a lot of value away. So, you have to have a sense of when the best time is to buy and sell options.

When you are trading options, you need to stay on top of it very closely. I have found that in a matter of hours the money I invested has doubled, so if I had been paying attention, I wouldn't have been able to sell them and take advantage of the profits. In other cases, option prices can drop quite fast as well. So, if you remember our discussion from day trading one of the things you want to do as you want to use stop-loss orders. You can use pretty much everything that you use trading stocks when training options. So, you can make sure that you don't lose your shirt on options as well. But of course, that's the time we're talking about a few hundred dollars so you're not necessarily going to lose you lose your shirt, but you probably don't want to lose that money.

Summary of Call Options

Looking at it from the perspective of buying a call option, and trading call options here is the summary. The first thing is the price of the option is quoted on a per share basis. So that means if the price is listed at $2.05 since there are 100 shares for every options contract, one contract will cost you $205.

You can buy multiple contracts at once if you want to, just so you know.

Buying a call option means that you have the right to buy those 100 shares at the strike price, that will be your right, but it's optional. That's why they are called options.

You would only decide to buy the shares at the strike price if the market price of the stock rises above that strike price. So, in that case, you would be saving money by buying the shares using the options contract.

But always keep in mind the vast majority of options contracts are not exercised. People try to make money off of trading them.

As a trader, what you're looking for is a dollar rise in the underlying share price. Then you want to look at Delta, and note that when the stock price goes up by a dollar per share, the price of the option will go up in proportion by Delta. We can use another specific example. Suppose that delta was .5. This means that if the price of the stock went up a dollar, then the price of the option to go up to $.50 per share. In turn, that means that for 100 shares, the price of the option will go up to $50.

The last thing that you need to understand about buying call options is if the share price drops below the strike price, in that case, the option loses massive value. They aren't worthless, but they are cheaper by a lot. As you get closer to the expiration date, the price is going to plummet if the price of the shares is still below the strike price.

If the option expires and the price of the shares is still below the strike price - that option is completely worthless on the expiration date.

Now on the other hand if the price of the shares is higher than the strike price for a call option, in that case on the expiration date the difference between the share price and the strike price is going to be the value of the option. Soon the expiration date, if the share price was $104 and the strike price was $100, the call option would be worth four dollars a share for a total price of $400. Of course, you would have to find a buyer, and it would have to be somebody that wanted to exercise the option. Because after the expiration date an options contract can't be traded any longer.

Writing Covered Calls

Viewing this from the other side, now let's look at a strategy that an income investor can use with covered calls. As someone looking to make monthly income, in this case, we're talking about writing a call option.

It's known as a covered call because you use shares that you own to cover the option as a kind of collateral. So, going back to our fictitious stock that was $100 a share, you might write a call option if you're reasonably confident that the price of the stock is not going to go above a certain value.

After all, an option is only valid for a few weeks in many cases, so depending on the volatility of the stock, it might be worth the risk. As an example, you might write an option contract for $103 strike price. Then you could sell that option contract and the money paid to buy the option contract from you, it's called the premium.

You get to keep the premium no matter what.

So that can be some income, and there is a strategy of writing covered calls on a repeated basis to earn a regular income. And the more shares you have, the more options contracts you can write.

So, in the event that the option contract was exercised you wouldn't really lose out on anything. Well, I'm not being 100% honest, you would lose out on the missed opportunity of the rising price of the stock. So, say, for example, that the stock rose to $105 a share. So, you could have sold the shares for $105 a share, but because you wrote the options contract, you might be forced to sell them for the strike price of $103 a share. This means that you missed out on a two dollar per share profit.

However, you still made a profit. If you are using the shares to generate the income, you probably bought them a while back, so maybe you paid $95 a share for them say. So, if you sell them for $103 per share, you still made a profit on the actual sales of the shares.

Plus, you got the profit from the premium. Going by the AMEX example, if you had sold the call option for $2, you add that to the strike price, and you're actually making $105 a share. Of course, this example is a little contrived, but whatever money you make from the premium can help make up the lost potential profits you

could have made from simply selling the shares without getting involved in an options contract.

In short, as a writer of a covered call, there really is nothing to lose unless you're very desperate about holding onto those shares. And in that case, you probably would not be thinking about writing an option anyway.

Also, since you end up with profits, you can use that money to buy more shares of stock and maybe you will look at something else instead.

Now guess what happens if the share price drops. In that case, the option expires worthless. So, you get to keep the shares, and you get to keep the premium that was paid to buy the option contract. To sum up, if you write covered calls, you basically profit either way the stock moves. A covered call is a very good way to make some money off shares of stock that you own.

You just have to accept that there might be some risk you'll have to sell the shares of stocks. So, depending on what you have in your portfolio, this can be making you some pretty good profits off of premiums each and every month. Just remember that they may exercise the option but something like 80% of options are never exercised. But there will be times when the options are exercised. But chances are in the vast majority of the time you will be able to keep your premium and the shares of stock. You can also minimize the risk of having to sell by picking a good strike price. And if you have multiples of 100 shares of stock, you can write multiple options contracts based on them and generate a really nice monthly income.

Put Options

Now let's talk about put options. A put option is the opposite of a call option in the sense that you try to profit from a decline in the stock price. The buyer of a put option has the right to sell shares of stock to the writer of the options contract.

One reason that people buy put options is so that they can have an insurance policy on their stock. So, in other words, it's a way to protect against huge losses. So, let's say you buy stocks at $100 a share and the share price plummets. Just for the sake of an

illustration, we'll say that it plummets to $20 a share. So, if you had done nothing, you would lose $80 a share. But on the other hand, if you had purchased a put option with the strike price of $95, even though the shares had plummeted, you would be able to sell your shares without much of a loss. They would be sold for $95 a share if you exercised your right on the option, and you would only lose five dollars per share.

Other people buy put options as a way to basically short the stock, so they are betting on profiting off a decline in the share price.

Note that in the case of put options, it's similar to that with call options in that people buy and sell the options just to make money off the trades. Therefore, most of the options are never exercised. However, if a put option expires in the money, there is always a risk that it will be exercised.

In the case of put options, they are going to make money when the share price drops. So that means if the share price drops below the strike price, then a put option becomes in the money. The reason is that the buyer of the put option would be able to sell the shares at a price that's higher than the market price. If the share price is equal to the strike price of a put option, we say that the put option is at the money.

Now let's look at the alternative scenario. Just like with call options, put options have an expiration date. If the share price is above the strike price of the put option at expiration, then the put option is basically worthless. So, if the expiration date is reached, we say that it's out of the money in that condition.

Hedging your bets

There are different types of trading strategies that people use to hedge their bets when they are trading options. So, you can buy call and put options simultaneously so that you can make money no matter which way the stock moves. Or if you're not that sophisticated, at least you can protect your losses. So, if you had bet wrong that the stock was going up but it actually went down and your call option was worthless if you priced a put option at the right straight price it would probably be in the money, and so you would make some profits from that instead.

There are many other strategies that can be used, they're very sophisticated, and beyond the scope of this book. Using those more advanced strategies will require training and experience and probably putting a lot of your effort into options themselves, which is probably not something long-term investors want to deal with. That said, you can make simple profits from trading options.

Chapter 10:
Beginners Mistakes

Investing in the stock market can be exciting. It can also generate feelings of fear and despair. These emotional rollercoasters can lead new investors into making bad decisions. Many new investors also fail to educate themselves about how the markets work and the things they need to pay attention to. We all make mistakes, and these factors and more can lead to costly mistakes that lead to loss of capital. However, if you take some time to educate yourself and prepare ahead of time, you can minimize your mistakes and the costs of mistakes that you do make.

Prepare Before You Start Investing

Many people who decide they want to get into the stock market are anxious to do so. However, it's important to prepare before you start buying shares. The first thing that every person should do is make sure that they have an emergency fund of cash stashed away, and that you will not use it to buy stocks or to cover losses. The purpose of an emergency fund is to have money on hand in case you hit the skids with a job or lose other sources of income if you have a car or medical emergency, or your basement floods and you need to pay for expensive home repairs. Recent surveys have shown that far too many Americans have been neglecting basic savings, and many could not even meet a $400 emergency car repair. If you are in a situation where you couldn't pay for a $400 car repair, then you are not quite ready to get into the stock market. You should work to save up a little bit of money first. Many experts recommend that you save up around six months of required funds to pay all your living expenses, and that is good advice, however that doesn't mean you have to wait that long to start investing, but you should at least get two months ahead before you start buying stocks.

Another important part of preparation is education. And congratulations, by reading this book, you've demonstrated that you are the kind of person who is willing to take time to learn before jumping into something! That is a very important consideration, especially when money is involved. You should also look into courses that are available online and read as many books as possible, especially when trying to determine what kind of risks you

are willing to take and how to marry your investment goals with that. There are many online courses available on basic stock investing, day trading, swing trading, options, and other topics. There are even many good videos you can watch on YouTube to get a grasp of many of the basic topics.

In recent years the development of simulators is one of the most exciting tools for education. These can be really useful, especially if you've never done self-directed investing before, but especially for those who are looking to be day traders, swing traders, or trade options. Practice makes perfect as they say, and that's as true with investing and trading as it is with anything else. If its important for a football player to practice before a game, its important for a new trader to practice day trading or options trading, before putting real money on the line.

Investing or Trading Based on Emotions Rather Than Facts

One problem with investing and trading are that emotions ride high. It's completely natural to experience emotional highs and lows as the stock market does its usual roller coaster ride. However, what you don't want to do is let emotions start guiding your decisions and taking you over.

The process of being guided by emotion can start at the very beginning when you choose your very first stock to invest in. Ask yourself a question – why are you choosing that particular company? Are you picking different companies because you think they are cool, or because you are really taking a cold hard look at company fundamentals? You should be selecting companies based on whether or not they meet your investment goals. So you should be looking at their earnings, their future prospects, the P/E ratio and other important metrics that will help you decide whether or not a company is 1) in good shape both now and for the long term future as far as you can see it, and 2) that the company actually helps you meet your investment goals.

Maybe you are in love with Apple. But being in love with Apple is not a good enough reason to buy stock in Apple. If Apple doesn't match up with your investment goals, you should be looking elsewhere.

Emotion has a huge influence when people are facing losses. People panic and sell off. When the Dow Jones starts declining, people start moving their cash into “safe” investments, many that these days don’t even pay hardly anything like money market funds. Some people don’t even do that and just sell out and take the cash.

As an investor, you need to be disciplined. The courses of action described in the last paragraph that is governed by fear and panic are not the courses of action that a disciplined investor is going to take. Now if you are a swing trader and the market is declining, then either you’re going to sell, or you’re going to be shorting the stock. If you are a long-time investor, however, you most certainly shouldn’t follow the lemmings over the cliff. What you should be doing is looking at a downturn as a buying opportunity. So, you should be loading up on shares, but don’t do it all at once. When the market enters a downturn, nobody can be sure how low it's going to go, so you want to make disciplined, periodic purchases the way you always do. Dollar cost averaging always works when you are in it for the long haul. That doesn’t mean you won’t miss some opportunities, but over time the market will rebound again, and by the time you are in your retirement years, the prices will be much higher than they were when you originally invested in most cases.

There are going to be some cases when you’re going to want to bail. An individual stock can decline for many reasons, and sometimes there is a point of no return. For example, Bear Sterns crashed from $170 a share to $2 a share over a matter of a few weeks. If you had invested in Bear Sterns, then you should have been studying the situation closely and you would have gotten out early.

So, you might want to bail from an individual stock when the data tells you that this is the right course of action. But you never get out of any stock simply based on panic. Know what the fundamentals are of the company.

Emotion works the other way too. When it seems like a stock simply goes up and up, people can start getting giddy about it. You might be tempted to put your entire life savings into that one stock. But that is a bad idea, no matter how good the stock is. As we’ve mentioned before, it's great to know that Amazon increased so much that an investment of a few thousand would have made you a

millionaire, but hindsight is 20/20. Right now, it's impossible to know which if any social media companies are going to actually bank profits and still be around in 20 years, so it would be foolish to put your life savings into one. The so-called investor who goes around claiming to know what the next sure thing is can be called nothing more than a fool.

Another problem is people get emotionally invested in one company. Maybe it's because of the mission of the company or the products it makes that people think are going to "change the world." But when you get emotionally invested in a company, you start becoming irrational. Good examples include Tesla and Theranos. Let's take the latter case. Theranos claimed to have invented a revolutionary means to let people test their blood and to have medications delivered. It became clear that it was a sham, but the people who were emotionally invested in the company and the female CEO were literally fooled about it – and some still are even though it's clear now that Theranos is done and the CEO may even be facing charges.

In the case of Tesla, the jury is still out. They make high-quality products but have problems with delivery and scaling. They may yet overcome those problems. But if you talk to many Tesla investors, they are zealots about it. If Tesla ends up going down the drain, many of the investors may go down with it. Is it worth it?

To avoid letting emotion take over whether you get swept up with the lemmings running off the cliff when there is a bear market, whether you panic when an individual stock starts dropping, or whether you get hyper-excited when your favorite company is booming, you need to have rules in place beforehand and follow them.

For example, one rule that you could have in place is you never invest more than 5% of your portfolio in any single company. If you do that, then you are not going to be damaged even if you're a bit taken in by the company or you panic when it drops – or worse – miss when you should get out. Think about the poor fools who stayed invested in Bear Sterns until the end, and even the government wouldn't bail them out.

This is one reason why I like ETFs, although you don't have to use

them for your entire portfolio. They divorce you from the problems that can arise when you start getting emotionally invested in one stock.

Putting Too Much Stake in the past Performance

One mistake many new (and even experienced) investors make is putting to much credence in the past performance of a stock. The fact is, as they say in the disclaimer, past performance is not a guarantee of future returns.

So, people often look at past performance as a guarantee of future performance when history shows that it is more often than not, simply not true. So, you might've seen a run-up of some particular stock over the last year, maybe it was Netflix, or maybe it was Amazon. And so, you just expected to continue. Of course, the real world doesn't work that way and the expected returns may not materialize. As it is, although none of us can tell the future, the run-ups of Netflix and Amazon may have come to an end. Of course, over the very long term, we probably expect both of those to grow. We simply don't know, so putting all of your investments into Netflix isn't a good idea, but you might want to put some of your investments into Netflix.

So, let's take Apple as another example. Apple has had an incredible run up over the past 10 to 12 years. Ever since they introduced the first iPhone, growth has been spectacular, expectations have been high, and returns have been even better. We really haven't seen anything quite like it before.

Apple is still a solid company, but one thing you can say is that it has run into a stall. Right now, nobody is expecting Apple to make the huge leaps that it did for the past 12 years. You could've invested in Apple in 2014 say and simply expected the run-ups to continue. What you couldn't foresee is that Apple was running out of new inventions already back then. Without Steve Jobs at the helm, it's hard to see Apple rebounding and getting back to the spectacular growth experience that they had before. Of course, you never know, maybe they will bring in some new management that has some of the talents that Jobs did, and they will recover their lead. But before you invest, you should be tracking what the company is doing.

So, I hate to beat a dead horse, but this is one that needs to be beaten. I spent a lot of time talking about index funds, but a lot of times that advice will fall on deaf ears. People that want to have a self-directed investment fund find them boring.

Here are the facts. There are some investors that have a fantastic ability to pick individual stocks that are going to be winners. And it's fun doing it. As I said earlier, I don't want to discourage you from picking your own individual stocks. But like I also said I tend to put 50% of my investments in exchange-traded funds. The reality is that most people don't have all the time in the world to be studying companies, market trends, and the like in order to pick good stocks.

Now if you do follow my advice and limit yourself to picking maybe 10 stocks, then you're on the way toward more success. At least, under those circumstances, you don't have to spend 24 hours a day studying companies in the markets. However, broad index funds that give you approximately the same returns as the total Stock market, so they are a fantastic way to invest and build long term wealth. The answer is to follow both paths even if you use a different asset allocation than I have.

Diversifying, but Not Really Diversifying

So, you build your investment portfolio. And you come and tell me that you've decided to go with picking all individual stocks. And then you tell me that you've invested in 25 companies. Sounds fantastic! But then you tell me they're all banks.

Remember that when you diversify, that doesn't just mean picking different companies. It also means diversifying across sectors, company size, and even investing in different types of securities like bonds. You might even consider investing in different overseas markets, including Europe, Japan, China, and developing countries. Diversifying helps you weather storms that don't impact the entire economy but might hit one sector hard. At the time of writing, because of trade disputes, you might be in a world of hurt if you invested in soybeans, while the rest of the economy is humming along. Diversification is so important it should be mentioned often.

Lured by Penny Stocks

One of the mistakes the new investors make is they get pulled in by seemingly easy money opportunities like penny stocks. Although it seems like a great idea, i.e., you can buy tons of shares for hardly anything, it is definitely not a good idea. One of the problems with Penny stocks is although some people can make money at them, is that the industry is full of charlatans. They know the new investors are going to come along and they aren't really going to be aware of what Penny stocks are about or how to invest in them properly. So, these charlatans take advantage of the new investors by making it seem like you can make far more profits from penny stocks then you really can.

Since the stocks are so cheap, in many cases, fraudulent people will buy up tons of shares of the stock in order to drive up its price. When something is a dollar a share or at most five dollars a share, that's not that hard to do. Then after the price goes up, they can document this in some kind of product that they might be selling like an online video course about penny stocks, or there are a lot of newsletters that fly about (usually online). People looking for fast money who are ordinary people with real needs and good intentions, but they don't really know what's going on, are easily swayed by this kind of publications. I'm here to tell you right now, you should not give in and join the crowd. If you're planning to be an investor, there is absolutely no reason to even think about penny stocks at all. Maybe one in 1000 will actually turn out to be a viable company at some point. But picking out that one in 1000 is a fool's errand. If you're a new investor, it's highly unlikely that you're going to be the one that picks out the winning penny stock.

Remember also, the price of something upfront doesn't mean that it's really a bargain. So, buying a one-dollar stock might be as good as burning your money in the fireplace. Of course, we are all familiar with the problem of buying a used car, and you know that when you're buying a used car, a bargain price is not necessarily a good sign. Yes, you might save money buying the car up front, but when it breaks down in the boonies two weeks from now and needs a new transmission, well the price has suddenly gone up hasn't it?

The same phenomena are at work with the vast majority of penny stocks. So yes, you can get a penny stock at a bargain price. You can buy 1000 shares for $1000. Boy, that sounds good compared to

Amazon where you can't even buy one share for $1000! Or Netflix, you might have two or three shares. The difference, of course, is that company that you bought your thousand shares in probably isn't going anywhere anytime soon, if ever.

There's a reason it's a penny stock isn't there?

So in the same way that you might be hurting yourself by buying a used car for $1000 that's going to break down on the road cause you trouble, and then require you to spend another $3000 to fix it, it's better buying a more expensive car where you pay upfront but you know it's reliable transportation.

If you were to invest in Netflix and only get those two shares, at least you would be making profits as they grew in value over the years instead of having thrown away $1000 on a pipe dream.

The bottom line with Penny stocks is don't go near them at all. In fact, I would advise that you don't even invest in micro caps, those are companies not ready for prime time. Yes, some of them might make the cut at some point, but your odds of picking the successful ones out are slim to none. Invest in real stocks, and that's where the real bargains are because they are going to grow in value over time. Something like Netflix, which is $360 a share now might be $500 a share in two years, or maybe even $1000 a share. I would call that the real bargain.

Are You an Investor, or a Trader?

The next big mistake made by beginners that we should address is not being clear if you want to be a trader or an investor. If you were going into this wanting to be an investor, you need to avoid the temptation of constantly trading stocks. Part of being an investor is choosing a solid investment from the get-go as much is that as possible, and then riding it out. That doesn't mean that you stick with it forever if it is not looking very good in the future at some point, but you have to give it a reasonable amount of time before bailing on the stock. And if you do decide to bail, do so not because of your gut feelings or because of a price drop which may be temporary, but because of the fundamentals and what they are telling you.

Remember that stocks are highly volatile over the short term. That

short-term volatility can disguise a long-term upward trend. If the fundamentals and earnings of the company are good, there's no reason not to expect that future rise in price. So, you should be avoiding the temptations to dump the stock. Short term fluctuations or even stalls over a few months should be ignored. For example, if it isn't going anywhere over three months or something like that or even if it drops for a month or two, that isn't a reason to dump the stock.

Another thing that happens to people is they get excited about buying stock in a few great companies. Then they keep watching the market, and they notice that there are some other opportunities coming up – hey why didn't I invest in those?

So, they get really excited and they sell the stock in the original companies and buy shares in these other ones. That's not a good approach that you should follow. I would say that you've got to at least commit to something for at least a year. At the end of each year, you can evaluate your portfolio and see if there are some stocks that you want to get rid of it in exchange for others.

And remember again that I am advising that you have 50% of your portfolio in exchange-traded funds and they should be index funds like the S&P 500. You can invest in funds like that and then simply not even think about them anymore, accepting the fact that you keep investing. You should be buying new shares and doing it every single month, but other than that, don't touch them. Those are there for long-term growth.

If you find that you're really intrigued by constantly trading stocks, even though you've set out long-term investment goals, maybe the truth is you're more suited for being a trader. Remember this about trading - studies show that most day traders fail to make a profit. That shouldn't be that surprising. I don't know if you've heard of a little rule of thumb called the Pareto principle or not. It says that in any endeavor, 20% of the participants make 80% of the money.

It's probably worse than that when it comes to day trading.

No, I don't want to discourage you completely, but if you decide you want to be a day trader or a swing trader, I really encourage you to take a course. Some courses that are available cost a lot of

money, and you might be looking at $1000 investment just for the class, but it's worth it and might save you tens of thousands later on. That's something I can guarantee you.

If you decide you want to be a day or swing trader, I have to say that I'm willing to bet a lot of money that those who take courses and prepare ahead of time outperform people who just jump on and start trading after reading a book.

So, you're probably going to want to be one of the people who take the course. It's an investment and it will be totally worth it. Some of the courses are taught by professional day traders who will actually work with you to make sure that you're learning the material.

Another suggestion that I have if you have goals of becoming a long-term investor, but you're intrigued by trading, is to take a small part of your capital that you have available for investing and instead of buying stocks with it, you buy and sell options. One reason to consider this is the fact that investing in options doesn't require as much capital to be invested. Remember you're talking hundreds of dollars at a time, while with day trading you might be talking $10,000 at a time, as we discussed in the chapter about it earlier. So, you can satisfy your urges to make short term profits by trading options with a small portion of your capital and then use most of your funds for long-term investing in stocks. That's a little bit safer than becoming a day trader and blowing all your money.

Getting Suckered by Gurus

Now let's look at another phenomenon that happens with regard to the stock market. Many people who are new to the industry end up trusting the wrong people. If you go online and there are endless marketers, courses, YouTube videos, and who knows what else applying for your attention, it's easy to fall prey to people that are peddling bad information. At the same time, there are lots of TV gurus dispensing advice about stocks. Of course, some of these are in financial shows and so forth but it can be hard to know what's right and what's not when you're just starting out. No, I'm not saying that all these people selling courses online or dispensing advice on television are fakes. Obviously, I wouldn't be saying that when I just advised you to look into a day trading course if you're considering day trading. There are some good people out there.

But it's hard to know who to listen to and who do not listen to. If you're going to be doing long-term trading, one person that I thoroughly trust and highly recommend is Bob Brinker. It's unfortunate for those of us still investing that he retired. But you should see if you can get podcasts of the many previous episodes of his show and just listen to them. In the show, he constantly dispensed his wisdom about stocks and he continually educated. You can also subscribe to his newsletter and sign up for market timer, and also look at the portfolios that he has set up as examples for different investment goals. In my view, there's no way that you can lose if you follow Bob Brinker for long-term investing.

Not Really Knowing Your Companies

One mistake the people often make when starting an investment career, is they fail to study the companies that they invest in carefully. We've already talked about choosing companies to invest in based on emotions rather than on the fundamentals. However, it needs to be emphasized that you also need to really know what the company is doing, how it's spending its research money, and what the long-term plans are for the company. You need to then look at whether or not those long-term plans are going to be viable for long-term profits. To gather all this information, the fact is you really need to study the companies very closely. Your investigations of each company need to be extremely thorough. That's one reason why diversifying by investing in say 50 different companies is probably not a good strategy. A range of 10 to 20 companies is far more realistic so that you can really understand where those companies are going. You also need to have a good handle on the leadership team at each company. Just reading a few brief articles about tweets that Elon Musk sent out is not good enough. You really need to know what he is doing what he's all about and the rest of his team that is leading the company.

Putting Money Where You Shouldn't Because of Financial Illiteracy

Let's face it, financial education in the United States isn't all that good, in fact, we could say in most places its non-existent. What we learn we get from our parents, other relatives, and maybe some friends. As a result, far too many of us aren't financially savvy and can be taken in by many different schemes. Some are more obvious

than others, but one is annuities. If people actually understood how they worked, it's doubtful that anyone would really buy into one. And no, an annuity is not an investment. People's financial illiteracy also makes them susceptible to "it's the next best thing" claims. You should put your skeptic hat on when you hear that. We aren't saying that it never happens, but chances are something people are crowing about isn't really the next best thing. You are the key to fighting your own financial illiteracy. Keep learning. Take advantage of all the books that are out there, and sign up for courses if you find one directly related to the eventual investment path that you decide to take. If there are investment clubs in your area, consider joining one. With all the information that is available, there are plenty of options to choose from.

Biting off More Than You Can Chew

If you have never run a self-directed investment account before, then its probably not a good idea to jump in as a day trader. But many people catching the excitement bug, overreach when they start trading stocks. The cold reality of this is that you should gain some experience before you start working your way into more risky activities. You don't have to sit back in a sweater with a pipe and buy an endless array of mutual funds, but you might want to hold off for a while on the day trading. Slowly learning to buy and sell stocks is a good way to get started. You should stick to simple trades for 3-6 months before considering anything else, and secondly, you should make sure that you can afford to lose any capital that you put into more risky ventures. Remember that a day trader account has a minimum requirement (in most cases) of $25,000. Can you afford to lose $25,000? If the answer is yes, and you would still have a large sum of capital available for more conservative investments, then you might be ready to get started on your day trading career. However, if you are in a situation where losing $25,000 is going to be something that is very noticeable and painful, then you're probably not ready to day trade. But look at the other possibilities. For example, people who want to become more active traders seeking shorter-term profits should be looking at swing trading.

Not Reinvesting Dividends

If you are a beginner, you should reinvest your dividends until

you've built up a significant portfolio. Many people do use dividends as a way to make a living, but if you are just starting out with your investing and you get a small dividend check that really isn't going to make a difference in your day to day life, you are probably better off reinvesting it. Grow your portfolio so that down the road, your dividend checks are so large you can live off the passive income.

Your Investments are Small

You should invest the maximum you can invest. Of course, that doesn't mean that you invest so much that you can't pay your utilities (I've been there). But you should invest adequate amounts. Otherwise you're not really going to get anywhere. Start with at least $500. You should live a more frugal life to make sure that you have more funds to invest. Your later self will thank you.

Not Having a Plan

Many new investors (and plenty of older experienced ones as well) don't have a firm plan in place. I advise that you start out by writing down your goals. Keep a journal. Make sure the investment goal you have in mind is clear. You should even be shooting for a specific amount of money over a given time period. So, work backward, think about how much money (realistically) you would like to have available at age 60. Then work out a plan that can help get you there. Of course, since the stock market is inherently unpredictable and who knows what could happen on the political front, there are no guarantees in life. But history shows that the stock market has been relatively stable for very long periods of time, and so planning for the future in a systematic way makes perfect sense. How well you actually stick to the plan you draw out is a personal decision you are going to have to deal with on your own.

Pulling out Too Early

There are two ways this can manifest itself. The first is the stock market starts crashing, you panic and pull your money out and put it in the bank – where it will earn next to nothing. The second way this can happen if you invest and make some gains, but then your mind starts wandering, and you get worried. You start thinking you

better pull out now while you're ahead. Both paths are fundamentally flawed. Remember that over the long term, the stock market always goes up. So, pulling out during a crash is the wrong move as we've mentioned before. During a crash, you should be buying stocks, not thinking about pulling out. As far as the second possibility, remember that over the long term, those that stay the course are the ones that always win. So, unless you're doing swing trading, don't book any profits. Let your investments sit and focus on adding to them year after year, let the fruit ripen for a long time period.

Chapter 11:
Individual Retirement Accounts

Another way you can consider investing as an individual is using an individual retirement account. These can be utilized in addition to the rest of your investment portfolio. There is no reason to take an either-or approach, in fact, both and all of the above is the correct answer. An individual retirement account or IRA, as its name implies, is something you set up on your own distinctly from your employer. So, an IRA is not like a 401k. Personally, I consider having an IRA as another form of diversification. It's not the main game in town, but its there and will be there in my retirement years.

One of the advantages of setting up an IRA is that you get certain tax protections. There are two main types of IRA's, and the way that they have tax protections is specialized for each type. So, one way you can set up an IRA is for tax-free growth of the investments. In the other case, it's a tax-deferred account.

Traditional IRA

If you set up a traditional IRA, the money is taxed when you withdraw it in retirement. So, there could be a little bit of risk. The United States government is in massive debt with problems with long term funding of social security, Medicare, and other problems. So how does anyone know what the tax rates are going to be in 10, 20, or 30 years? That is one risk to consider. However, the money in the account is allowed tax-free growth, and you can deduct your current contributions to the account from your taxes now.

Roth IRA

A Roth IRA involves after-tax contributions. So, you pay taxes on the money now, and then invest it in your account. Then it can grow tax-free and when you withdraw the money, it's tax-free. However, there are certain conditions that need to be satisfied in order to use a Roth IRA tax-free in this manner. A single person must earn less than $122,000 per year in order to contribute fully to a Roth IRA. For married couples, the cutoff is a household income of $189,000.

Contributions that you can make to an IRA are limited. For a Roth

IRA, if you are under 50, you are allowed to contribute $6,000 per year. If you are over the age of 50, you can contribute an extra $1,000, which is used for “catch up” money, so someone over the age of 50 can contribute $7,000 per year.

If your income is too high to qualify for a Roth IRA, then you will have to use a traditional IRA, which means you’ll be stuck paying taxes in the future no matter what they are, while your Roth buddies are rolling in the dough.

The government generously allows you to contribute to a traditional IRA up to 70 ½. You can take out distributions early, but if you are younger than 59 ½, there is a 10% tax penalty. Contributions for a traditional IRA have the same limits as a Roth.

The Bottom Line

An IRA offers a chance to build up another retirement account. You can buy IRA’s through your broker. The small contribution amounts probably mean that for most investors, and IRA is not going to be their main mode of investment anyway. However, as I said in the introduction to this chapter, an IRA offers another safety valve, it can help to make sure that you don’t wipe out all of your investment funds should things go wrong.

Chapter 12:
Annuities

We conclude the book with a brief look at annuities. We are doing this for informational purposes because annuities are not investments. They are a kind of insurance. The idea behind an annuity is to guarantee a fixed income payment for life in retirement. As they are a kind of insurance, they are sold by insurance companies. This makes buying a good annuity a troubling prospect. Earnings from an annuity are taxed as regular income by the government.

You don't need to buy an annuity ahead of time. There are immediate annuities available. The way this works is that you pay the insurance company a one-time lump sum of money. In exchange, they guarantee you a fixed income stream the rest of your life. They also come with a death benefit.

You can also get a deferred annuity. Some of the rules of a deferred annuity are similar to those of IRAs. For example, if you buy a deferred annuity but opt to take payments before age 59 ½, you get a 10% tax penalty, which is the same rule for IRA withdrawals. In fact, the account used for a deferred annuity is basically a mutual fund, but the insurance company guarantees a fixed payout. You can even purchase an annuity inside an IRA. My advice is don't soil your IRA by doing that.

A deferred annuity also comes in with a built-in 7-year delay, so you can't pull out any funds until the seven years is up without paying heavy fines.

There are two major types of annuity contracts. A straight life policy will pay out based on life expectancy. The payments will continue even if they exceed the original amount paid in. However, if the beneficiary dies, the payments stop.

For life with period certain, there is a 10 or 20-year time limit built in. But a surviving beneficiary gets the payments until they run out.

Besides getting the fixed payments, you can make a withdrawal. A systematic withdrawal can be paid quarterly, semi-annually, or annually. You can also take a lump sum payment of the entire amount, which sounds like it basically erases the annuity.

Drawbacks

Annuities are often saddled with lots of fees and commissions. This basically leaves people who are naïve at a disadvantage, and the insurance salesman has a motivation to force people into annuity contracts. Large commissions can lead insurance salespeople to act in their own best interest rather than in the interest of the client. Also, the guarantee of the annuity is only as strong as the insurance company. If it folds, you don't get your payments. We all saw how strong big AIG was.

The idea of an annuity can be appealing for a lot of people, for the simple reason that the idea of regular, fixed payment to your bank account in old age sounds like security. However, you should look under the covers for this one. Generally speaking, you are better off simply putting your money elsewhere. Invest your money where it can grow and you can provide yourself with regular income payments in old age without having to have paid huge sales commissions to some insurance agent, only to be followed by hefty fees paid to the insurance company. With all the investment options available today, there really isn't any reason to consider an annuity.

Conclusion

Thank you for taking the time to read Stock Market Investing for Beginners! I hope that you found this book informative and enjoyable.

With the advent of the internet and other technologies, the stock market is more accessible to small investors than ever before. In this book, we've reviewed how to get into investing in stocks, bonds, options, ETFs, and mutual funds. The variety of ways that you can invest are seemingly endless but also offer unprecedented opportunities. I hope that readers will take advantage of them to grow their own wealth and do it the right way, carefully and over time.

You could simply set up an IRA or 401k and forget it, but managing your own portfolio is fun, interesting, and can lead to more returns both over the short-term and the long-term, allowing you to grow your wealth faster and to enjoy the fruits of your labors in your retirement. Of course, you may not ever actually retire, you may find yourself actively investing and trading in stocks to keep the money rolling in!

We've also covered trading strategies for the more ambitious, including day trading, swing trading, and options trading. These methods can be profitable, but please remember that they do carry extra risk. Follow the advice given in the book to minimize your risk as much as possible.

Remember that all investing carries risk, and despite following all the strategies described in this book, you may still lose money. The information we've provided here is for educational purposes only and does not constitute financial advice. Your own situation will be entirely unique. When you are unsure about an investment move, please consult a professional financial advisor.

DIVIDEND INVESTING FOR BEGINNERS

How to Build Your PASSIVE INCOME and FINANCIAL FREEDOM through the Stock Market: A Guide to Retire Early with Dividend Stocks

Introduction
Welcome to the era of super low-interest rates!

Probably ever since the beginning of finance, people relied on banks and bond payments to make money from interest. This is called income investing, and for many ordinary people, having money in a savings account that paid good interest was one of the few ways that they could grow their wealth. In the mid to late 20th century, nearly every middle-class household had a savings account in the bank and conservative investors bought high-interest rate products that were safe like CDs.

Unfortunately, because of a lot of factors including bad decisions by the Federal Reserve and the housing crash, times have really changed. We've now had two decades of incredibly low-interest rates by historical standards. They are so low that your money is basically wiped out by the modest inflation we have. You'd be better off putting it in a mattress than buying a money market fund.

While years ago you could make 6% or 7% interest from multiple investments, and put your money in lucrative and very safe products from banks like CDs, today, those same investments only pay 1 to 2%. What a joke! This has left many people struggling, looking for another way to make a safe income from investments. Many people are leery about putting their entire life savings into the stock market, where it could crash and lose most of its value and not recover in time for retirement.

Unfortunately, over those same years, people have also developed bad savings habits. Recent surveys have shown that the majority of Americans could not even pay $500 cash to cover the smallest of emergencies.

Since you've decided to read this book, I can only assume that you have other ideas for your money. At the very least, I have to congratulate you for thinking about what you can do to increase not only your wealth but also your income.

In this book, we are going to take a look at one of the safest ways you can increase your income, while still utilizing the stock market. Over the past 20 years, the stock market has been growing in leaps and bounds, even including the 2008 financial crash and the major

recession after the dot com bust. As they say, the rich get richer, and as interest rates continue to drop, money kept flowing into the stock market.

Of course, the stock market has also been driven by technological changes such as the advent of the Internet, smartphones, the gig economy, and innovative companies like Netflix and Tesla. But the fact remains that a lot of money is going into the stock market in part because interest rates are so low.

Another safe investment that people used to rely on a great deal were bonds purchased from the United States government. Now, money is continuing to flow into those bonds, but for the ordinary person, they don't offer the value that they once did. Interest rates are ridiculously low on the treasury issued by the United States government. They do have an inflation-protected option, but the amount of interest you would earn on the US government bond pales in comparison to what it would've paid in the 1990s or earlier.

So, in this book, we're going to explore a path that is going to be safe and lucrative for most investors. It's going to take time to build it up, but if you do have a lot of capital to invest right now, you've got a Headstart. Even if you don't have a huge amount of capital, any amount you can start investing in the plans described in this book is going to go along way towards securing your future. Despite the low interest rates, there is still a way that you can earn passive income off of investments and it's relatively safe.

Of course, we are talking about dividends. Many large companies that are relatively stable still pay good dividend payments. For those who are new to the subject, a dividend is a cash payment that the company will pay out of their profits every quarter to stockholders. Payments are calculated on a per share basis.

So, to build your passive income over time, all you need to do is purchase shares on a regular basis. Of course, you have to know the right companies to invest in and all the issues associated with dividends, and what dividend investing entails. We hope to answer all those questions for you in this book.

So, let's go ahead and get started!

Chapter 1:
Overview and Advantages of
Dividend Investing

In today's world, we all have a sense that we need to grow our money. Many people would also like a source of passive income and a way to add to their income in retirement. Living off Social Security isn't really an option for any quality-of-life. Unfortunately, far too many depend only on Social Security. It wasn't that long ago when people could rely on FDIC insured banks to not only grow their money but also to act as a source of passive income. Bonds, which are basically loans that a private individual makes either to a government entity or to a corporation, also used to be a reliable way to earn interest payments off of your money. Back in the days when you could earn 6 to 10% interest from bonds, it was a very safe and lucrative way to earn money. It's hard to believe that in 1990, which really wasn't that long ago, you could actually buy US treasuries and earn solid money off of them every six months. You also have the guarantee of safety for your principal that was in the hands of the United States government. Of course, today, the government is in massive debt and the debt continues to grow. Now, the government is actually threatened by rising interest rates. Already, paying interest is practically becoming as large a part of the budget as the defense budget is. Can you imagine a world in which the government is paying more money for interest on its debt than it is for national security? That is a pretty crazy situation.

So, as we alluded to in the introduction, there is still a safe way that investors can protect their principal at least to a certain degree and also earn a passive income. This is by investing in dividend stocks.

There are different ways that you could do this, but one way that provides the remarkable benefits of growth that the stock market can provide, with at least a certain degree of safety, is to invest in solid companies with growing dividend payments. Later in the chapter, we are going to look at a few companies that serve as examples. But before we get into that, let's explain what dividends are and how they work for people who are beginners when it comes to the subject of dividend investing.

A basic overview of what dividends are

So, first things first. Right now, the stock market continues to provide a way that you can grow your money at a pace that is faster than inflation. Many people are understandably leery of the stock market because they lived through at least the 2008 financial crisis, and many others are old enough to remember both the recession after the 9/11 terrorist attacks and the dot com recession that happened in the late 1990s. You also don't have to be that old to remember black Tuesday in 1987. So many people have a misperception of the stock market-based in part on those crashes and also based on the misperception that the stock market is a gambling casino. Now, of course, if you approach it that way, the stock market could be a gambling casino. And many people do approaches this way by engaging in speculation such as day trading stocks in an effort to earn fast profits. We won't get into that here, but it goes without saying that most people are not disciplined enough to make money from those kinds of activities. The reality is most people trying to make quick cash in the stock market. But the fact that many people do succeed at such activities always keeps those dreams of making fast money in a day or two alive.

Of course, if you're interested in dividends, you are a more realistic and sensible person when it comes to handling money. You realize that investment and not speculation is the time-tested and true way to grow your money over the long-term. The fact is the long-term investors who buy-and-hold and don't panic always come out ahead.

The great depression and the 2008 financial crisis both illustrate why it is stupid to panic and pull your money out of the stock market during downturns. Let's take a look at the 2008 crash first. For our benchmark, we'll just use the Dow Jones industrial average. Although it's not the best benchmark probably, the valley of the Dow is what most people associate with the stock market, and of course, it does track with all the other indices.

According to the St. Louis Federal Reserve Bank, on July 10, 2009, the Dow Jones industrial average was 8146. Two years later, it was already over 12,000. The market had already grown by about 54% at that time. By the time Pres. Obama was about to leave office in late December 2016, the Dow Jones industrial average was about 19,700 points. So, since that first date we quoted, the stock market

had basically grown about 142%.

Now, those are some returns. Hopefully, our readers are aware that you can buy index funds that track major stock market indices. So, imagine what you're money could've done investing just in the Dow Jones industrial average over that time span.

Now, of course, we are not trying to peddle the idea that this kind of growth is always going to happen. The point of this exercise is only to illustrate that recessions, even major ones, are temporary events. The overall growth of the economy and the capital in the economy is something that is a constant growth factor, and that's been proven over a very long period of time.

So, we can even see this in the mother of all recessions, the great depression of the 1930s. In July 1929, the stock market was experiencing an unprecedented rise in value. It was nearing the 5000-mark at that time. That is pretty incredible given that the economy was much smaller back then. By the summer of 1932, the market has dropped all the way down to about 842 points. Now, that seems pretty dismal and it definitely was. There were many factors that led to this; one of the most important was the Smoot-Hawley tariff act, which nearly single-handedly killed global trade. The Federal Reserve, which at that time had only been around for about 15 or 16 years, really didn't know how to handle the crisis. So, another factor that kept the depression going and worsened its effects is that the Federal Reserve severely reduced the money supply. Had these two events not happened to, add to the stock market crash, the Great Depression would've been much milder.

Those issues are for a discussion on another day. What's important for us is that from 1932 onwards, even though it was still a very difficult decade which included the rise of Adolf Hitler and Japan launching wars across Asia, the stock market experience great rebounds after 1932. Four years after Franklin Delano Roosevelt had been elected; the stock market had risen by 236%. Now, of course, I wasn't alive in 1932, but if you would have advised people in the summer of 1932 that the best thing they could do was to invest in the stock market, they would've thought you were completely crazy. And yet those people that did invest would have seen absolutely amazing returns.

We don't want to get too caught up in this, the point you should take away from this is that even the most drastic shocks to the stock market are temporary and are followed by great rebounds.

Another thing to consider is that things don't grind to a complete halt during economic downturns. For those who have lost their jobs, if they don't have any life savings, of course, an economic downturn is a major crisis. And yet, there are still massive amounts of economic activity going on. Even during the depression when unemployment rates reached record levels, most people were still employed. The same holds true for the 2008 financial crisis. If you avoid the temptation of looking at the size of the economy in relative terms comparing it to just a few years earlier which is what a recession actually does and look at it in absolute terms, even in the depths of the 2008 financial crisis, the United States economy was absolutely huge. Don't get me wrong, I'm not trying to downplay the huge problems that there were and the necessity to deal with them. But remember this. Even during an economic downturn, people need to get their prescription drugs, they still watch television, they are still using electricity, and they're still buying basic goods like toilet paper and food. So, here's a hint. A company like Walgreens which is an old established company based on providing vital daily goods is well-placed to survive an economic crisis.

All right, we spent enough time on this detour. But I hope that for those who are leery of the stock market, that is an objective review of some of the data makes them feel a little bit more relaxed about placing their money in the stock market. In the next section, I'm going to go over a couple of general strategies that will help you avoid getting financially destroyed by the fortunes of one single company or a single sector of the economy.

The Importance of Diversification

One of the most important strategies any investor in the stock market can use is diversification. Many people understand this to mean that you will take your money and put it in maybe 20 stocks or something like that. That kind of gets the idea. However, it doesn't go nearly far enough. In the next chapter, we are going to talk about diversification in detail. But I don't mind mentioning it multiple times because it's so important. So, let me say this, putting

your stock in 20 different companies is the bare minimum that you want to do in order to protect your capital. These days, we're only left with the choices of protecting our capital in nominal value by putting it in a bank or investing in bonds, contrasted with putting it at risk in the stock market. I think, by now, you're convinced that putting your capital in the bank or in bonds is something a little more attractive than bearing it in your backyard. With that in mind, that means we need a strategy where we can protect our money by taking advantage of the growth of the stock market.

And, of course, a major theme of this book, is actually also to take advantage of dividend payments for income, and moreover, seeking dividend payments that are growth-oriented. So, in the end, you really don't need a bank account except for emergency savings. And let me do my duty at this point and encourage you to put a great deal of effort into building a small savings account to help you weather problems that may arise in your life. If you don't have a savings account or if you do and there's hardly any money in it, I recommend that you make a goal of getting $20,000 into that savings account. Now, you don't have to do that all at once, but set a goal that is at most 24-36 months out, to put regular monthly deposits into your savings account. After that, just leave it alone, unless it's a true emergency.

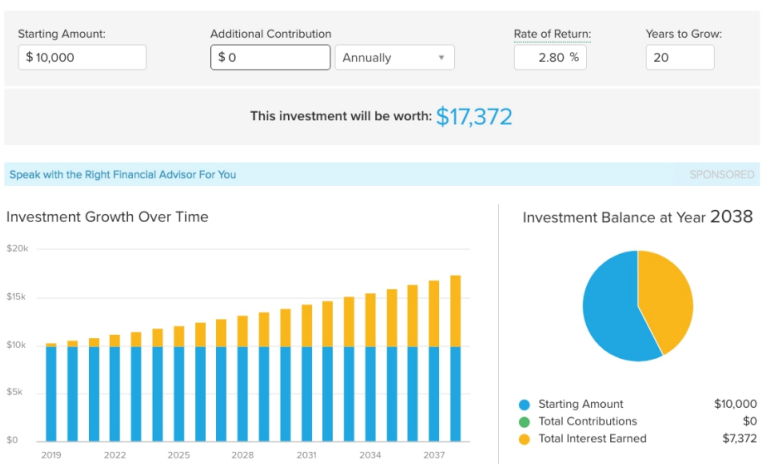
A Brief Look at Compound Interest

Anytime that you learn something new, you need to become familiar with the definitions of that niche or industry. First of all, let's recognize that dividend investing really has two goals.

The first goal is to leverage the stock market and the capital appreciation that it provides in order to grow our wealth over time. Many large and stable companies are obviously not going to be growing as fast as the hottest new stocks like Amazon, Netflix, or Google. However, they are going to be growing and probably much faster than inflation. When it comes to the stock market, many people have a shortsighted viewpoint. They have a Time window in mind that is short-term and so they are always looking at the ups and downs that take place over a year or two or even day-to-day. But that is not the correct way to look at it if you are a serious investor. You need to look at what happens to your money over long time frames. So, let's consider a 23-year time period to see

what actually happened to Walgreens stock prices. For the record, Walgreens isn't exactly the best stock. But in 1996, it was about eight dollars a share. At the time that I am writing this, Walgreens is about $30 a share. So, its value has grown by 275%. If you had bought $10,000 worth of shares in 1996, you would have about 1,250 shares that would be worth $37,500 today. And we are imagining that you just bought the shares and didn't keep investing.

If you're going to compare that too what would happen to your money in a bank, you're going to find that the bank is hardly worth anything at all in comparison. Let's use a 20-year United States Treasury bond as an example of current interest rates. Right now, according to the St. Louis Federal Reserve Bank, the interest rate on a 20-year treasury bond is 2.8%. If you invested $10,000 into something that had an interest rate of 2.8% that was constant, after 20 years, you would have a little more than $17,000. That's a lot less than you would have by buying stock in Walgreens. So, here is a graph that I created at Smart asset.com showing how your money would've grown if you invested $10,000 into something that paid 2.8% interest and assuming you put no additional money:



To be completely honest, I'm not sure why anyone would even consider this. Inflation is going to wipe out all of your gains. Now, of course, having $17,372 in the year 2038 would be a little better than going into your backyard and digging out the original $10,000, which we assume you protected by putting in a treasure chest. But if you were putting your money into Walgreens, as crazy

as it sounds, you would be far better off. And we haven't even considered the fact that Walgreens pays dividends on top of the growth that it experiences in the stock market. And probably more to the point, there are many stocks that you can choose that are far better than Walgreens.

What is a Dividend?

So, now, let's turn our attention more directly to the topic of the book. The first thing we should make sure that everyone understands is what a dividend is. Simply put, a dividend is a share of the profits of the company for the previous quarter paid to stockholders in cash. The share that you're provided is obviously proportional to the number of shares of stock in the company that you own. Typically, the amount of the dividend is calculated as a percentage per share. Dividends are paid out on a quarterly basis. As we will see later, you can earn dividend income buying individual stocks or by buying into a fund like an exchange-traded fund. A great approach to investing is to have a portfolio that contains a little bit of both. As far as mutual funds, there is no reason to invest in mutual funds anymore. Mutual funds have a strict disadvantage in the high fees that they charge and the fact that they only trade once per day after hours. Exchange-traded funds give you all the benefits of mutual funds but without all the hassles and expensive fees. They trade just like stocks so you can buy and sell them at will on your own.

Please be aware that some companies pay dividends in shares of stock rather than cash. Of course, you can choose to keep the extra shares as a form of reinvestment, or if you are looking to make cash you can sell them for the profits.

Ex-dividend Date

The ex-dividend date is an important date that you need to know about if you are investing in stocks that pay dividends. The first thing you need to know is that the ex-dividend date is a cut-off date that is used to determine who will receive a dividend payment on a stock. In order to receive the dividend payment, you must own the shares of stock before the ex-dividend date. If you buy the shares of stock on or after the ex-dividend date, the seller of the shares will receive the dividend payment. This is also called the ex-date.

Date of Record

The date of record is that date at which a company will determine who is eligible to receive a dividend payment. People who own shares of stock two days before the date of record are eligible to receive the dividend payments.

So, let's suppose that on September 16, 2019, some hypothetical company announces that it will pay a dividend on October 1, 2019. The date at which it will determine which shareholders of record will be eligible for the dividend payment. For the sake of example, say that the company announces that shareholders "of record on the company's books" on September 23, 2019 will be eligible for the dividend. That means that the date of record is September 23. I picked that date for an example because it's a Monday. The ex-dividend date is going to be one day before the date of record, but it is one business day. So that means the ex-dividend date, in this case, will be the previous Friday, which is September 20, 2019. In order to be eligible for the dividend payment, you would have to pay on the shares before September 20, 2019. So, if you bought the shares on September 19, you would receive the dividend payment. But if you bought the shares on September 20, you would not receive the dividend payment, but the person who sold them to you would be the one who receives the dividend.

The date the announcement was made which in our case is September 16, it is called the declaration date.

The ex-dividend date can be looked up on any website that provides information for stock tickers. For example, you can use the free website, Yahoo Finance, to get this information. Of course, the next ex-dividend date won't be available until the company announces it, so it might list the most recent ex-dividend date. As a smart investor, you should buy your shares well before the ex-dividend date.

While the ex-dividend date won't necessarily be listed as current, you can find stocks that pay dividends to see if they have one listed or if it says N/A meaning not applicable.

When are dividends paid

Typically, dividends are paid on a quarterly basis, in January, April,

July, and October.

Dividend Yield

In order to find good stocks to invest in one of the characteristics that you're going to look at as a dividend investor is the dividend yield. This is given as a percentage which is why the term yield is used. The dividend yield is the percentage of the current share price that determines the amount of cash per share that is paid out each quarter. Of course, day to day, this value is fluctuating, but you can look at it to get an idea of how much money you can make. To know a value close to the exact amount, you'll want to be checking these numbers on the date that they announced that they will be paying the dividend. But mostly, check a few examples to get an idea of what you're looking at.

While dividends are paid out on a quarterly basis, note that dividend yield is calculated based on annual payments. The formula is:

Dividend yield = (Annual Dividend)/Share price

The way that annual dividend is calculated varies. Sometimes, the annual dividend is the dividend paid by the company over the past fiscal year.

Yield is basically a measure of ROI or return on investment. That is it tells us how much return the investor gets for every dollar invested. Of course, when you look up a company on say, Yahoo Finance, they are going to give you the calculated yield using the current share price, which may be quite a bit different than the share price that you paid to invest in the company.

The dividend yield is heavily influenced by changes in share prices as well. You can see that the yield will go down if share prices rise, while it will increase as share prices decline.

Advantages of Dividend Investing

Investors who are looking for a way to earn a passive annual income will benefit the most from dividend investing. This is the closest you're going to get to earning interest on a savings account which amounted to a significant amount of money that you would have in the old days. If you choose your investments wisely, it's a

relatively safe way to invest in the stock market as well, since companies that pay dividends tend to be older and more solid. You're also looking at the stock market in true investment terms rather than hoping for the excitement you might get from buying and selling shares to make fast profits.

People are always looking for ways to earn passive income. You could try starting an online business to earn passive income, and that might work faster in the event that you succeed, but the reality is most online businesses end up going nowhere or losing money. Depending on how much capital you have available, you can start earning a passive income right now from dividend stocks that are pretty much automatic. Generally, since you're probably not a zillionaire already, it's going to take longer for you to earn income from dividend stocks, but over the long term, it's also far more solid.

Two ways to potentially realize gains

If you buy shares in a new company that doesn't pay dividends, you're only able to realize gains from the price appreciation of the shares. You're hoping to buy low and sell high at some point. However, while you have an ownership stake in the company, your profits are locked in. During the time that you own shares, you can't realize any of the profits to require you to sell. With dividend stocks, however, you are earning money off the shares themselves, while you hold them. However, you're also gaining wealth from the price appreciation of the shares, if it's a good stock. So, you gain from asset appreciation the way you would in owning shares in a company that doesn't pay dividends but you're also getting an income from the dividend payments in the meantime.

Newer companies don't pay dividends

Paying dividends is giving the stockholders a share of the quarterly profits. Mature companies with stable cash flow can afford to do this, but newer companies that are looking for rapid growth can't. A company that is looking for rapid growth is going to reinvest its profits back into the company rather than pay them out. Of course, mature companies aren't going to pay all their profits out as dividends. They are probably going to reinvest a portion of their profits in their operations as well, but they aren't looking for the

kind of rapid expansion a new company is looking for.

Relatively low risk

Most of the stocks you are going to buy as dividend investments are going to be companies that are solid for a very long time. While it's true they may not be quite as dominant ten, twenty, or thirty years from now as they are at the present time, companies that pay dividends tend to have a solid long term outlook. You are going to care about the earning potential from the dividends far more than you are about whether the company is undergoing massive stock appreciation and disrupting its markets. Also consider that you can be moving your investments around as conditions warrant, so you can sell stocks that become less attractive and invest in new ones with better prospects. As we'll see, you can also do very well by investing in funds that hold large numbers of dividend-paying companies.

Types of Dividend Investments

Let's briefly look at the types of dividend investments you can make. We will look in more detail at each of these in the book.

- High Yield Strategy: this type of investment strategy is used if you're looking to obtain the maximum dividends (i.e. income) now. When you use a high yield strategy, you'll be investing in slow growth companies that pay high dividends.
- Growth rate strategy: If you adopt this strategy, you're looking more toward the future, so you'll invest in companies that might be paying lower dividend yields now, but they are experiencing higher than average growth. A company that pays dividends but has a low yield might be in that position because the company is rapidly expanding and trading with a high price to earnings ratio. This is a buy-and-hold strategy that is suitable for investors looking to earn most of your profits from dividends in the future. Of course, if the company is paying dividends, you are going to earn some money now even though it's not as much as you could be earning from high yield, slow growth companies or from your investment in the future, assuming it works out.

- REIT: This is a real estate investment trust. They trade on stock markets and are income-producing investments.
- MLP: This is a master limited partnership, which is an LLC that is publicly traded. As an investor, you are a limited partner in an MLP, and not involved in the actual operation of the company. You will receive quarterly distributions of profits proportional to your ownership stake.
- BDC: This is another less conventional way to earn quarterly profits, BDC means Business Development Company. A BDC is an entity that invests in small to midsized businesses. This provides you a way to earn profits from smaller companies, and it's often described as a venture capital fund that is open to all investors, rather than being closed the way a venture capital fund is. A BDC essentially acts as a pass-through entity, so the profits are passed through to the investors. You can invest in a BDC on stock exchanges, and they can pay handsome yields. However, this is a higher risk type of investment.

Finding Companies that Pay Dividends

Finding companies that pay dividends is easy. You can just look on your brokerage site or use a free site like Yahoo Finance. Look to see if the company has a dividend yield and ex-dividend date listed. This will tell you if the company pays dividends. Yahoo Finance lists the Forward Dividend, which is an estimate of what the future dividend payment per share is going to be. Keep in mind that is an estimate and also keep in mind it's a short term estimate. But it can give you some idea of what your earnings per share would be. Dividends are quoted on an annual basis but you get paid quarterly. So, if you see a dividend of $2.00 per share, that would mean you get a payment of $0.50 per quarter and the quoted value is subject to constant change.

Chapter 2:
Figuring Out Income from
Dividend Payments

In this chapter, we are going to take a close look at how much income you actually make from dividend payments. We will go over some formal definitions and concepts and then use some specific examples, and look at how different investment strategies can impact your earnings both now and over the long-term. Note that when you are reading company data that has the amount of the dividend in dollars paid per share, you have to be aware as to whether they are discussing the annual basis or quarterly basis. Most of the time, the annual payment is listed.

Determining dividend payments from Income Statements

In order to determine the dividend payment a company is making, you need the income statement and beginning and end balance sheets. What we need to know are the net income (profit or loss) and retained earnings. When we say retained earnings, this is the cash reserves on hand for the company. Retained earnings are given by cumulative net income minus cumulative dividends, so the difference between net income and the change in retained earnings will tell us the amount of money that the company paid out in dividends.

Dividend payment = net income – change in retained earnings

So, the change in retained earnings is the amount the company didn't pay out in dividends, so its money reinvested into the company, for new plants, equipment, R &D, or whatever the company chooses to spend its money on in order to generate continued growth. If net income is equal to the change in retained earnings, then no dividends were paid out.

Dividend Payout Ratio

One indicator you'll want to pay attention to is the fraction of profits that a company is paying out in dividends. You actually don't want it to be too high, because that doesn't leave much wiggle room if the company needs to reinvest more of their earnings into company operations or if earnings start dropping. With all things being equal, if the company needed to do so, that could mean a

smaller dividend payment to your account.

Dividend Payout Ratio = (total dividend payment)/ (net income)

Investors also talk about the retention ratio, which is a measurement of how much cash the company retains. This can be found using the relationship:

Retention Ratio = 1 – Dividend Payout Ratio

Growth-oriented companies are going to have a low dividend payout ratio. This is because they are reinvesting most of their earnings (or often all of their earnings, many growing companies like Netflix pay no dividends at all). Older companies are not expected to be as aggressive for growth, and so they tend to have higher dividend payout ratios.

You also have to consider the sector or industry the company is in. To determine whether the dividend payout ratio is reasonable for the company, you'll need to compare it to other companies that are at a similar level of maturity in the same industry to get an idea. For example, it would make sense to compare Walgreens and CVS, but it wouldn't make nearly as much sense to compare Apple and Walgreens.

People often look at yield, but the dividend payout ratio may be more important. Yield gives a snapshot of return on investment (for the current share price). This measure, on the other hand, tells us what the company is actually doing with its cash flow.

Shares Outstanding

The number of shares outstanding is given by:

Shares outstanding = shares issued – shares in treasury

Shares in treasury or treasury stock are shares that the company keeps in its treasury. These are shares the company has bought back. Shares outstanding give us one way to get the amount of money paid per share:

$ Paid Per Share = (Net Income)/ (Shares Outstanding)

Dividend per Share

For many investors, this is the key piece of data they want to look at since it's the actual cash (if the company makes cash payments) that they are going to receive. Dividend per share is the amount of income from the company that you're going to get as a cash payment. The formula is just:

Dividend per share = (total dividend paid)/ (shares outstanding)

You can get the total dividend paid using the data in the previous section. Dividend per share is also given by:

Dividend per share = (Earnings per share)/(Dividend Payout Ratio)

If you are reading financial statements, unless you're investing in preferred stock, you'll want to look for dividends declared for common stock.

Top Reasons Companies Pay Dividends

Since companies have the option of paying dividends or not, it can be helpful to look at the reasons why companies would choose to pay them. We already have an idea of why companies would not pay dividends. Usually, new, growth-oriented companies don't pay dividends because they are reinvesting their money back into the company. That doesn't mean that strong, growth-oriented companies don't sometimes pay dividends. Apple, for example, pays dividends despite its near-record growth over the past decade or so. Of course, Apple had already been around a long time.

Paying dividends can be taken as a sign that a company is strong and confident about the future. If they are able to comfortably pay dividends and reinvest in growth, then that makes the company look solid. Paying dividends is also a mark of maturity. When a company has been around a long time and it's well established and mature, we usually expect that company to pay dividends. Of course, a mature company may not be aggressively pursuing growth.

What dividends indicate – given the company's ability to pay them, is that the company has a positive outlook about future earnings.

Dividends are also a good way to attract new investors to the company. While many investors are only seeking capital appreciation, there are a large proportion of investors that want to

earn income off the dividends as well as enjoy the benefits of capital appreciation.

Note that if a company stops paying dividends or the dividend-price is reduced, this can have a negative impact on the share price. Elimination of dividends is definitely seen as a negative by investors. For that reason, if a company is going through a period of low profits or even losses, they may try to maintain their dividend payments if they have future expectations that they will turn things around.

An older company may want to reinvest earnings as well as new companies that are looking for aggressive growth. They may be interested in mergers and acquisitions (sometimes referred to as M & A), building new plants, entering new markets, developing new products, or investing in other new assets.

Investing in Preferred Stock

Investing in preferred stock is another way to get into income investing that is a little bit different than buying shares of common stock (when people talk about stock, they are usually referring to common stock). The dividend paid out to owners of common stock is dependent on the earnings of the company. Preferred stocks are also traded on a stock exchange. However, in some ways, they function like bonds. Preferred stocks have a fixed interest rate that is similar to the coupon rate of a bond. You can invest in preferred stocks directly, or you can invest in an ETF which invests in a large number of preferred stocks on behalf of investors in the fund. If you are interested in investing in order to receive income payments, preferred stock may be an option. They tend to pay higher yields, and preferred stock is generally liquid. However, it may be harder to sell preferred stock at your asking price than it is common stock. This will only be an issue if you are investing in single company preferred stock, if you invest in an ETF, the fund manager is handing buying and selling of shares that make up the fund, since an ETF works like a normal stock (its like a common stock in fact) buying and selling shares of a preferred stock is going to be a simple matter.

Preferred stock is becoming less common among most companies, except for the banking sector. Today, the vast majority of

companies that offer preferred stock are banks. These companies include JP Morgan Chase, Bank of America, and Wells Fargo. If you don't mind investing in the banking sector, preferred stock may be an option to include in your portfolio. Dividend payments and yields for a preferred stock can be quite good, however. Bank of America, for example, at the time of writing, is offering a dividend of $72/share (annual) with a future yield of 5.59%. The preferred stock BAC.PL is $1,300 per share, however.

Trailing, Current, and Future Dividend Yield

Note that dividend yield may be quoted for different scenarios. Trailing dividend yield is based on the dividend paid over the prior period (usually the last year). The current dividend yield is given by:

Current dividend yield = (most recent full-year dividend)/current share price

The future dividend yield is an estimate of the future yield. It uses current stock price and the dividend used is an annualized version of the first dividend paid for the year.

How much do I need to invest?

One question new dividend investors often have is they want to know how much they need to invest in order to make a certain level of dividend income. In most cases, you'll have to invest a pretty significant amount, and so, for a lot of people, the best strategy is to plan for building up a dividend investing portfolio over a long period of time. If you have access to several hundred thousand dollars of capital now, then you could start enjoying the income payments immediately. The amount that you need to invest is going to depend on yield, but like anything else in life, there are tradeoffs to be made. A company paying a high yield may have weaknesses that otherwise make the investment unattractive. Let's take a look at some specific examples to get an idea of what the market is really like.

The first thing you are going to want to do is set an income goal. So, let's say that you want to make $36,000 (before taxes) from your dividend income. Now, let's look at several ways that we could go about doing that. You can use a diversified portfolio, of course,

and in chapter 4, we'll talk more specifically about setting up a dividend portfolio, so, in these examples, we'll look at some different examples of using one stock in order to reach our goal.

Let's start with a well-known heavyweight and suppose that you wanted to invest in Apple. Checking the stock ticker, Apple is currently trading at $175 per share. We'll use the quoted forward dividend from Yahoo Finance to make our estimate. It lists the forward dividend at $2.92, and the yield as 1.46%. Remember the dividend quoted is the annual payment. We'll first need to know how many shares we need, which is going to be the income we desire divided by the dividend paid per share. So, now its simple math, and we have:

Number of shares = $36,000/$2.92 = 12,329

To invest now and start getting the income, the amount we need to invest is:

Amount to invest = 12,329 x $175 = $2,157,575

That is a pretty hefty sum. If you have two million dollars that is sitting in the bank or invested in other stocks that don't pay dividends, that might be a good use for it. If you are a new investor just starting out, acquiring that much Apple stock is going to take you quite a bit of time unless you win the lottery. Whether it's going to be worth it or not is hard to say. It's difficult to predict what's going to be happening in five years in the tech sector, much less in 20 years.

What if you bought that Bank of America preferred stock we mentioned earlier? The forward annual dividend for that stock is $72, but of course, the share price is much higher. This time we only need:

Number of shares = $36,000/$72 = 500 shares

Amount to invest = 500 x $1,300 = $650,000

So, you see how yield and share price can be pretty influential. Some people reading this won't have access to $650,000 cash either, but more people will have access to that than they will two million dollars. Banking is probably not something that's going to go away, so it might be worthy of parking the $650k in the Bank of

America preferred stock if you wanted to immediately generate that income.

The range of yields and share prices is quite dramatic, and there are many very low-priced stocks that offer high yields. Consider Consolidated Communications Holdings. Chances are, not many people reading this have even heard of it. This little stock trades on NASDAQ, and right now, it's trading for $4 a share (over the past 52 weeks, it did go up to $14 a share). The beauty of this one is the dividend yield of 38%. The annualized dividend payment is $1.55. So, let's look at how much we'd have to invest with this one in order to generate an annual income of $36,000.

Number of shares = $36,000/$1.55 = 23,226

That's a lot more shares than we'd need for either Apple or Bank of America, but this would only cost:

Amount to invest = 23,226 x $4 = $92,904

Now, we're getting into a range of investment that is more accessible to a lot more people. But you'd have to do research and find out who Consolidated Communications Holdings is and what their outlook is. Given the very low share price, it might not be that good (we leave it to you to do the research and find out). So, you'd have to ask yourself if you could afford to lose that $92,904.

Let's look at the Vanguard High Yield Dividend ETF. So, in this case, rather than buying stocks in individual companies, which can carry risk, we're investing in an exchange-traded fund. This is a fund that has invested in a large number of stocks that pay dividends, but rather than investing in the stocks themselves, we are buying shares of the fund. The dividends that are earned by the stocks in the fund are divided up and paid out to investors owning shares in the ETF in proportion to their ownership stake. The ticker for this fund is VYM.

Its dividend yield is 3.2% with an annualized dividend payment of $2.61. So we'd need:

Number of shares = $36,000/$2.61 = 13,793 shares

This is about Apple in terms of the number of shares. However, it's trading at $82. So we have:

Amount to invest = 13,793 x $82 = $1,131,026

This is a better investment than Apple. The reason is this ETF invests in 412 different companies. So, you get immediate diversified exposure, and you only have to invest $1.1 million instead of $2.1 million in order to realize the annual income of $36,000.

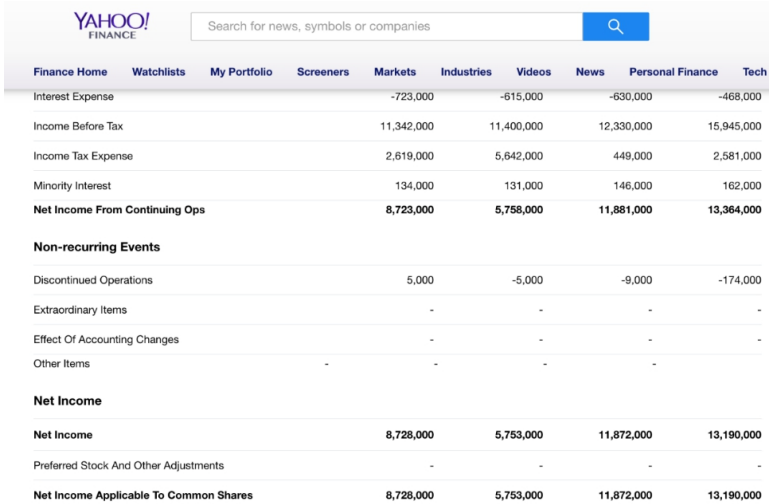
And over time, you have no idea what's going to happen to Apple. If it turns out that its best days are behind it, then you'd have to exit the stock, perhaps at a loss. When you invest in the Vanguard ETF, you're never facing this issue, since the fund manager is keeping up a solid portfolio that is highly diversified.

Example: How to Estimate Earnings

In this example, we're going to look up a stock ticker on Yahoo Finance and estimate the earnings from dividends per year that we'd make if we bought 500 shares. For our example, we're going to use IBM. It's a relatively older company that is still doing fairly well, so it's a good example of a mature company you might want to invest in if you were looking for a solid dividend stock. It's in the high tech sector, and although it's not anywhere near the heights it enjoyed in the 1980s when it was partnered with Microsoft, it would still be a solid addition to any portfolio. It's weathered many ups and downs both in its own fortunes and in the economy at large, and it's adapted to changing conditions by retooling its central mission.

Looking up IBM on Yahoo Finance, we find that it's trading at $127 per share. So, to buy 500 shares, it's going to cost us $127 x 500 = $63,500.

Yahoo Finance is a pretty useful website, especially because it's free. We can obtain financial reports for a company right there. Doing this for IBM, we can bring up the income statement. We actually don't need to look at these details, but let's do it just so you can see where things are located. You might want to refer back to our definitions earlier, but we immediately scroll down to find the net income and the net income applicable to common shares. IBM doesn't issue shares and so these are both the same:



Interest Expense	-723,000	-615,000	-630,000	-468,000
Income Before Tax	11,342,000	11,400,000	12,330,000	15,945,000
Income Tax Expense	2,619,000	5,642,000	449,000	2,581,000
Minority Interest	134,000	131,000	146,000	162,000
Net Income From Continuing Ops	**8,723,000**	**5,758,000**	**11,881,000**	**13,364,000**
Non-recurring Events				
Discontinued Operations	5,000	-5,000	-9,000	-174,000
Extraordinary Items	-	-	-	-
Effect Of Accounting Changes	-	-	-	-
Other Items	-	-	-	-
Net Income				
Net Income	**8,728,000**	**5,753,000**	**11,872,000**	**13,190,000**
Preferred Stock And Other Adjustments	-	-	-	-
Net Income Applicable To Common Shares	**8,728,000**	**5,753,000**	**11,872,000**	**13,190,000**

Dates move from right to left, so 2018 is listed first at 8,728,000. Note that these numbers are in thousands, so the net income is $8.73 billion.

Next, we'll take a look at the balance sheet. Scroll down to Stockholder's equity. Here we find the retained earnings are 159,206,000 (again, in thousands) for 2018. For the previous year, we see the retained earnings were 153,126,000. So, the change in retained earnings was:

Change in retained earnings = 159,206,000 - 153,126,000 = 6,080,000

This is in thousands, so the change in retained earnings is $6.1 billion.

However, we really don't need to be going through the calculations. We can pull up the shares outstanding from the statistics tab, where we find that for IBM, the shares outstanding are 886.64 M.

Now, let's pull up the cash flow. The cash flow statement will tell us how much they actually paid in dividends in the past year. We are writing this book in the spring of 2019, so we'll use the data for the calendar year of 2018. Click on Financials, and then select Cash Flow.

Scrolling down, we find that in 2018, IBM paid 5,666,000 in

dividends. Again, this is in thousands and so that is $5.67 billion. The dividend payment (annual) per share was:

Dividend per share = $5.67 B/ 886.64 M = $6.39 per share

The forward dividend, quoted on the Summary tab, is $6.28. That is an estimate but these are pretty close in value. But we'll use the real data, IBM's dividend payments seem to be relatively consistent.

So, if we bought 500 shares, we could expect to earn approximately:

$6.39 x 500 = $3,195

per year from the investment. Since dividends are paid out quarterly, we could expect to see a check from IBM in the amount of approximately $798 per quarter.

Special Dividends

A special dividend is a dividend payment that a company will make that is separate from its usual dividend payments. Sometimes, a company that doesn't pay dividends at all will make a special dividend payment. Companies may make a special dividend payment before a breakup or simply to get rid of some cash that it doesn't want sitting around. A special dividend is a one-time payment, and so, it's unlikely to impact the usual statistics you can look up about the company and their dividend payments. Depending on the fraction of the dividend payment, it can be subject to special or regular rules. Those subject to regular rules follow the rules that we outlined for dividends and payment dates discussed in the first chapter. A regular rule is followed when the special dividend is less than 25% of the share price. If it is 25% or more, then the special rules are followed. In this case, the payment is made and the following day is the ex-dividend date. If you sell the stock in this case and the sale falls after the record date but before the ex-dividend date, you will be paid the dividend but you must turn it over to the buyer of your shares when it's credited to your account. Option prices might be adjusted when there is a special dividend payment. Call option holders are not entitled to a special dividend.

Since a special dividend is a one-time event, it's not something that

you should be thinking about when developing your overall dividend investment strategy. You can think of it as basically a random event, and it may or may not happen for any stock you own. But it will have no long-term impact.

Chapter 3:
Important Investment Strategies

Some companies that pay high yields will allow you to reach the desired income goal without having to invest nearly as much money. But are they good investments? What criteria can we use so we don't foolishly park our money somewhere and end up losing it? The bottom line is you need to do your due diligence to make sure that the company sticks around for a significant amount of time and that it keeps paying good dividends. Also, if you need to sell your shares, you're going to be able doing so without taking too much of a hit. We'll also look at some different investment strategies you can employ to help improve the odds of success.

Are Bargains Worth It?

Some new investors might be tempted by stocks with low share prices that pay high dividend yields. Let's go back and look at Consolidated Communications Holdings. You'll recall that you could grab this stock at just $4 a share. The annualized payout for dividends is $1.55, which is comparable to many well-known companies. But who are these people, and is it safe to give them your money?

The first thing we'll note that is in the company's favor is they are trading on a major exchange, the NASDAQ. Being able to get listed on a major exchange is the minimal requirement that we could look for when doing due diligence.

First off, let's check out the company. It turns out this is a broadband company. From their website we find:

Consolidated Communications Holdings, Inc. (Nasdaq: CNSL) is a leading broadband and business communications provider serving consumers, businesses, and wireless and wireline carriers across rural and metro communities and a 23-state service area.

So, at least this appears to be a real business, and it's in a solid industry, apparently offering a focus on bringing broadband to rural areas. Looking at the history of the company, we find that it began trading on NASDAQ in 2005. Looking the company up on Wikipedia, we also find that they acquired a company called Fairfield communications, which allowed them to expand into 24

states. Since 2012, they've acquired four different companies.

It's hard to say whether that's good or bad right off the bat, they may be expanding too quickly for their own good by taking the easy way out by buying up similar companies. We are asking these questions because we'd like to get some understanding as to why the stock is only $4 a share. In fact, checking the history of the stock, we see that in late 2016, it was trading for $28 a share. Even at the beginning of 2019, it was around $11 a share, so we'd need to find out why it has dropped so much. In fact, we find that it plummeted all of a sudden in April. Looking at the quarterly financials, we see why – there was a net loss of $7.62 M in the first quarter, and more importantly, the year-over-year change in revenue was down 4.88%. However, this company still brought in $338 million in the first quarter, and lookup up their financial statements, we see that gross profit went from $421M in 2016 to $787M in 2018.

So, the company has some things going in its favor – and the price makes it look like a tempting buy. Let's summarize:

- The stock pays a really high yield.
- The dividend payment is fairly solid at $1.55 a share.
- The shares are dirt cheap, so we can acquire a lot of them and have an income stream right away.
- The company is in a good industry, broadband.
- From 2016-2018, gross revenue showed a solid and steady increase.
- Looking it up on Dividends.com, we find that it's been paying absolutely standard dividends. That is the same amount each quarter, at $0.3874 per share each quarter.

And here's a shocker. The company was founded in 1894! So, it's an older company, which offers us some assurance, given the very low stock price could indicate you'd be losing your equity soon if you put a bunch of money into this one.

Looking it up on Zacks.com (a good resource), we find that Zacks rates this stock a strong buy. It's also rated in the top 1% for its industry. Grades for value, growth, and momentum, are A, A, and B, respectively.

Checking Morningstar.com, the stock is rated hold. Not as encouraging, but they aren't advising investors to dump it.

So, it appears the disappointing quarterly earnings report made the share price crash. The next step you might want to invest your time in is learning about the company. What we need to know is what the company's plans are to improve its fortunes. In the news, we see that they've invested in a major project, expanding their fiber network in Des Moines, Iowa. That is probably a good start, but you'd need to read up on the company to make a decision. Remember, to earn $36,000 a year from this company, we'd have to invest roughly $91,000. So, it comes down to: are you willing to lose that money if things don't improve?

When investing, you can always put a stop loss order to sell your shares if things go south, so that you don't lose everything. On this company, we could put a stop loss of $3.50 a share, say. However, it's hard to imagine if this stock keeps losing the value that you will even be able to sell your shares. Remember that even though you're going to be doing your trades from a computer online or even on your smartphone, a real buyer has to be willing to pay your Asking Price for you to sell the shares. If this company is not turning its fortunes around, then there might not be anyone willing to take the shares off your hands at $3.5 a share – or at any price. This isn't like IBM, where if you needed to dump it, you could find a ready buyer.

There are other risks besides the stock price declining even more. If the company's fortunes don't improve, they may stop paying dividends altogether. In that case, you'd be stuck with worthless stock and it won't be paying dividends.

Of course, this is an older company, and it's been through a lot in the past century. There is a chance that they have a solid plan to turn things around, and part of your job as an investor is to read all of the publications the company puts out and any news articles you can find in order to determine this.

How to Evaluate Companies to Invest In

So, that was an introduction to finding a cheap stock and seeing whether or not it's worth it. Remember the old adage that you get

what you pay for. In many cases, buying a solid stock, even though it's going to take either more money or more money and more time (that is, if you don't have the money to invest right now to generate the income you want), but it might be worth the extra effort. You can start slowly and build up over time.

The first thing to look for when evaluating a company is how its profits are trending over time. If you are a more cautious investor, then you're only going to want to select profitable companies, and probably only profitable companies who show steadily increasing profits. Those with a taste for some risk might be interested in companies like consolidated communications, that can be bought cheap, pays a dividend, and if the company gets profitable, the share price might rebound.

It's good to pick companies that are profitable, but better to pick companies that also show steady growth in their profits. As a part of your due diligence, you'll want to pay special attention to the cash flow reports for the company. Solid cash flow means money will also be flowing to dividends. Another reason to look at cash flow is we can get a handle on what the company is spending its money on, and what the trends are. Looking at Consolidated Communications, we see something interesting. Their capital expenditures increased significantly from 2016 through 2018. In 2016, (in thousands) the capital expenditure was 125,192. This increased to 181,185 in 2017 and was 244,816 in 2018. This might be one reason for the losses in the first quarter of 2019. The company has been putting a lot more effort into capital expenditures. This could be laying the groundwork for future profits; by helping them build out the infrastructure they need as a broadband company to acquire lots of new customers.

Let's have a look at some other companies.

This time, we'll take a look at a solid company called Abbvie, Inc. (ABBV). The current share price is about $75. According to Yahoo Finance, the forward dividend is relatively high, at $4.28, with a forward dividend yield of 5.39%. This looks like a very solid investment, unlike Consolidated Communications.

Looking at their financials, they have shown steady growth in their gross profit for the past 4 years. Looking at 2015, 2016, 2017, and

2018, we see gross profits of $18.6B, $19.8B, $21.5 B, and $25 B respectively. The company grew 16% from 2017 to 2018, which is about the upper limit you'll want to look for. Generally, you want to be aiming for companies that fall within a range of at least 5% annual growth up to about 15% annual growth. Companies that are growing much faster can create some issues with stock pricing if they fail to meet "expectations", and for dividend investing, we're also looking for companies that have their feet on the ground, so to speak, and so these would be companies that are growing steadily. AbbVie seems to fit this profile very well, and when you combine that with the high $4 dividend, this looks like an excellent investment. The share price is also reasonable. It's solid, but not too high. Let's check AbbVie to see how many shares we'd need right now for an annual income of $36k.

Number of shares = $36,000/$4 = 9,000 shares

Amount to invest = 9,000 x $75 = $675,000

For most people, that is still a hefty sum, but if you had that saved up in your retirement account, would it be worth moving it into an investment with this company? If you did, you'd be looking at getting a $36,000 payment every year rather than just having your money locked into a given stock. If you don't need the income right now, the $36k would be a nice bit of money to reinvest in AbbVie to increase your holdings each year or to invest in other stocks to diversify and grow your portfolio.

If you are just getting started with dividend investing, then AbbVie looks like it is a solid candidate to consider.

Let's look at some of the other metrics you'd want to consider when choosing a company to invest in. One of these is whether or not there has been growth in the dividend payment. To find out, pull up AbbVie on Yahoo Finance and go to the chart. Then, select the 5-year time frame.

Doing this, we find that recent dividends are ranging between $0.96 per share to $1.07 per share (per quarter). Looking back to 2017, we see that AbbVie was paying $0.64 cents per quarter, which is quite a bit lower but still a good dividend payment. This is a very good sign that the dividend payment has increased if you are a

growth investor. Looking back to the beginning of the 5-year period, we see that at that time, AbbVie was paying around $0.49 cents per quarter. That is still a good value actually, for a benchmark comparison, remember that Apple at the time of writing is paying $2.61 annual.

Now, let's take a look at how the share price has changed over the 5-year period. At the beginning of the period, AbbVie was trading at $54 a share. Now, it's $75 a share, so the share price has shown appreciation. If you can find a stock with solid appreciation in the share price as well as in how much they are paying out in dividends, that's a great indicator of a solid growth company. However, if you pull up the chart, you'll notice that in early 2018, it was trading for $123 a share. So, the stock price is quite a bit lower now, and it would be good to do some digging to find out the reason why this drop occurred. By October 2018, it had dropped to $80 a share, so it's been steadier since then so this isn't necessarily a catastrophic signal, but you'll have to put some more research into this to find out what scared investors away. Looking at the year-to-date chart, we find that the stock price has been fairly steady since the beginning of the year. By the time you are reading this, things may have changed in this regard. But so far, the company still looks like a good buy. But you have to be careful with a situation like this, you don't want to get in a bind where you want to get rid of the stock but doing so would leave you in a situation where you've lost a lot of the original capital you've invested. Let's say it dropped to $60 a share, and you decide you must sell because it's steadily dropping. At that point, you're looking at selling your 9,000 shares for 9,000 x $60 = $540,000. Remember that we purchased the shares for $675,000, so this amounts to a $135,000 loss, which is pretty substantial.

One way you can protect yourself from these types of situations is to use a stop-loss order. That is an order you place with your broker to sell the stock if the price gets below a specific value so that you can limit your losses. A stop-loss order is only executed if the share price matches or goes below the price you set in your order, otherwise, it's ignored. So, in this example, you could put a stop-loss order at say $70 a share.

That kind of technique is often used by day and swing traders to

protect themselves from losing their shirts when they get themselves into speculation that went totally wrong. It's not entirely clear that is a good move with a stock like this, however, and you have very different goals if you're a dividend investor as compared to a swing or day trader. Remember that a stop-loss order is an automatic process. Since these shares are not just about momentary share price but also the income that they provide, you're going to be far more interested in the long-term prospects of the company. Placing a stop-loss order doesn't give you any room to think about your trades before executing them. That is good when you're a day trader, and you're trying to keep emotion from pushing you into a situation where you make bad decisions that can mean the loss of a large amount of money over a couple of hours, but when doing dividend investing, you're in it for the long haul, and so, you'll have to evaluate the long-term fortunes of the company and carefully consider them before making a move like that.

Another way to protect your investment is to buy a put option. This would give you the right to sell your shares at a fixed price, which is called the strike price. If you look at buying options, you'll find that there is a very wide range of strike prices, so you can set a level that you are comfortable with. But the advantage of this approach over stop-loss order is that it's an option. That means you are not required to sell the stock, ever. But you can sell it if you decide to. Let's see how this might work. Keep in mind that options contracts have an expiration date, so you'll need to look into that as well, and prices for the options increase the further out the expiration date is. The type of option you would buy in this case is a put option, which is something you'd exercise if the stock price crashed. In short, a put options contract is an insurance policy on your shares.

You could buy a put option with a strike price of $73 a share. The person that wrote the put options contract is required to buy the shares, and they have to pay the strike price, no matter what. So, in this example, if the share price dropped to $60 and the consensus was that it's going to keep dropping and this company is no longer a good investment, then it might be a good idea to sell at that point. But since you've purchased a put option, you can sell the shares for $73 a share even though the stock is trading at $60 a share. Ignoring for the moment fees and commissions, you'll get $657,000

from the sale.

But one other thing we need to look at is the cost of buying those put options. They are sold in lots of 100 shares per options contract. To protect your investment of 9,000 shares, you'll need to purchase 9,000/100 = 90 options contracts. So, let's find out how much these costs.

Looking up some options that expire in 3 weeks, a $73 put is priced at $0.94. That is a per share price, so you'd have to spend $94 to buy it. To get 90 options contracts, it would run $8,460. If we go out a full month, it's even more expensive at $1.19, or $119 per contract. That means you'd have to spend $10,700 a month to protect your investment, which is generating $3,000 a month. Obviously, this doesn't make much sense as a strategy.

So, you're better off using your judgment instead of relying on a stop-loss order. One advantage of a stop-loss order over a put option is that it doesn't cost anything. Buying "insurance" by purchasing put options can have significant costs, even though the cost is small relative to the amount of capital invested. Using put options might be reasonable if you are only trading stocks for their capital gains, as we saw in the example, they easily wipe out your dividend income.

One consideration to take into account with stop-loss orders is that stocks that are highly volatile might inadvertently trigger the stop-loss order. A highly volatile stock is one that has a price that fluctuates rapidly up and down over short time periods. So if a stock trading at $100 was highly volatile, over a trading day, it could drop to $96 a share, then up to $102 a share, and then back to $100 a share. If you were happy with $100 a share but had placed a stop-loss order at $96 a share, you would have seen your shares get sold even though you wanted to hold them as long as it was coming back to $100 a share (or higher).

So far, AbbVie looks like a fantastic buy for a dividend investor. Let's review the reasons why:

- It shows steady growth in gross profit, year to year. But it's not growing super rapidly.
- The share price is reasonable. It's priced where you would

expect it to be for a solid company, but it's not too high. So, we aren't paying an arm and a leg for the shares, but its not some questionable stock like Consolidated Communications (which fits the definition of penny stock by the way, which has been modernized to $5 a share, but we consider also that it's trading on a major exchange).

- Dividends have been steadily growing. In fact, if you pull up the chart, dividends are higher now than they were when the share price was above $100.

Something else you'll want to look at is the fraction of net income that is paid out to dividends. Looking at dividends paid out by AbbVie over the past four years, we see they increased each year from $3.3B, $3.7B, $4.1B, to $5.6B in 2018. Net income in 2015 was $5.1B, so the percentage paid out in dividends in 2015 was 65%. In 2018, the percentage of net income paid out as dividends were 98.1%!

That may be an unhealthy situation. The company may not be investing enough capital back into their own operations and growth, and they may be using the high dividend payment as a strategy to attract investors in order to make up for other deficiencies.

Let's have a look at what this company does. The first thing we find is that it's a biopharmaceutical company. Revenue nearly $33 billion and 29,000 employees. That's a great sector with a lot of growth expected going forward, but you'll also notice that this company is a spin-off of Abbott Laboratories, a company founded in the 1880s- so mature and stable. So, we'll want to find out why Abbott decided to spin it off. Doing a bit of research, we find that Abbott wanted to split into two companies because they wanted to focus on medical devices, branded generic drugs, diagnostic assays, and nutritional supplements. AbbVie is actually the drug research arm of the original company and was the reason the company was founded in 1884. According to several articles, investors believed that Abbott was splitting the pharmaceutical part of the company off because that loss of an important patent for a drug called Humira was imminent. At the time, Humira accounted for half of the revenue.

Since this is a company built around the development of new

pharmaceuticals, you'd want to know how much money they are investing in R & D. According to Statista.com, the company spent $3.3 billion in 2014, $4.3 billion in 2015 and 2016, $5 billion in 2017, and $10.3 billion in 2018.

From the perspective of wanting to see a pharmaceutical company developing new drugs that will come with patent protection, and hence, increasing the value of the company, it should be taken as a positive that they have ramped up their R & D spending. That increase in spending might be why the fraction of net income going to paying dividends has significantly increased, and this looks like a positive. The company is paying a solid dividend and is forward-looking in doing what they need to in order to drive long-term growth.

Looking at some of the news, there are some negative stories, and they may help explain recent declines in the share price. For example, we see that AbbVie sued the National Health Service in Britain, but the suit was dismissed in 2018.

Overall, I'd be comfortable making this investment and would be very pleased with the high dividend payment. It also looks like the company is willing to increase their dividend payments regularly and so is looking out for the interests of investors, and not just looking for rapid growth. You may have a different opinion and find that some of the negatives put you off when considering investing in this company, but we wanted to illustrate some of the things to look at when considering a dividend investment. Would I consider AbbVie over IBM and Apple? Yes and maybe. The reason is it's got more growth potential and it pays a high dividend. Apple's growth potential seems to have stalled, and its dividend is quite a bit less. In the case of IBM, it doesn't look to have much growth potential right now, but a $6 dividend payment is quite enticing. Probably a mix of AbbVie and IBM stock would be desirable.

Reinvesting Interest

One of the main principles used to grow wealth is to reinvest your earnings. This is the strategy that Warren Buffet used to grow such massive levels of wealth. Of course, he lives in the same house he's lived in for decades, and you might not want to grow large amounts of wealth for the sake of having it on paper. Most people go into

dividend investing in order to get an income from the investment, in terms of cash that they can spend.

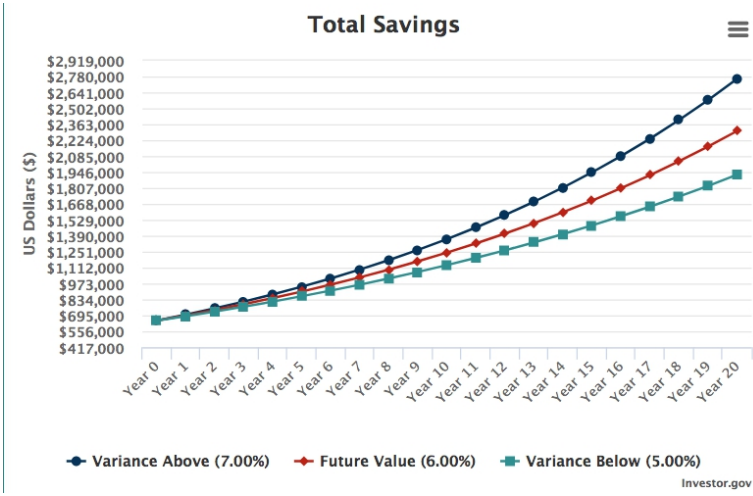
So, the first thing that you're going to want to look at is what your central goal is when it comes to dividend investing. Some of the different goals a person might be looking at include:

- Wanting a steady income ASAP. Maybe you already have significant capital you're willing to invest in dividend stocks, anywhere from $500k to $1-2 M or more.
- Growing your wealth over time. Maybe you're younger and want to build up as much net worth as possible for future dividend payments that could be used for income for early retirement, or even for a conventional retirement between ages 65-70.
- Maybe you're not looking for income from dividends at all, but you like the idea that they generate cash – money that you can use to invest in other assets. After all, you could invest in a company that doesn't pay dividends and hope for appreciation in the stock value, or you could find high-growth dividend stocks that also offer the opportunity for stock price appreciation, but at the same time, pay cash dividends, and then you can use the cash they generate to acquire more stock each year. This strategy can be very effective if you're having trouble raising cash to buy significant amounts of stock going forward.

Therefore, it's clear that what we do with the cash that the company's pay us each quarter is going to depend on why we are involved in dividend investing in the first place, and it's also going to depend on where you're at.

Let's revisit the concept of compound interest. This time, we'll consider a 20-year investment period, where we invest $650,000 in an investment that is paying a dividend with a 6% yield. We'll add a variance of 2 points, that is, the interest rate can fluctuate between 4-8%. We'll also suggest that we invest an additional $500 a month. What happens after 20 years? In this case, we used a calculator found on investment.gov. After 20 years, at 6% interest and contributing an additional $500 per month, you'll have

$2,305,351.60. This is what we see when we plot the data:



Even at 4% interest, you're looking at having grown your principal to around $1.8 million. That's pretty substantial. And that is the power of compound interest, especially when you add to your principal each month with new investments.

If you were buying AbbVie stock, for example, you could buy between 6-7 shares per month at the current share price, and so would substantially add to the number of shares with time. For the sake of simplicity, we'll say that conditions will stay about the same (of course, they won't over a 20-year time period, but this is just to give you an idea of how you could build your investment). So, we start with 9,000 shares that generate $36,000 in annual income, but we're putting that $36,000 back into the stock. That will give us an additional 480 shares per year at $75 a share. If we also put an additional $500 a month, we could buy another 75-80 shares per year. We'll say 78. That means each year; we add 558 more shares to our investment. After 20 years, we would have 11,160 more shares than we started out with. Our total number of shares would be 20,160. If it was still paying $4 a share, you would be looking at $80,640 in annual income 20 years from now, at which point, you could retire and simply live off the dividends.

Now, of course, these numbers are contrived. We haven't taken into account inflation or how much the dividend payment will change. Over a twenty-year period, there is a lot that can happen; the

company could even go under. However, we doubt that would be the case for a pharmaceutical company that has been around since 1884, but then again, Bear Sterns, which appeared rock solid until the final months before its demise, no longer exists.

The calculator used above was a simple interest rate calculator. In fact, dividends can be more powerful than simply earning interest rates. You can find calculators that will estimate the value of your holdings at a future date and annual income from dividends, assuming that you're reinvesting the dividends. Of course, like the exercise we just did, they are suggestive but have limited value. They are basing their calculations on certain assumptions about the growth of the share price of the stock. Let's set one up at a useful website named dividendinvestor.com. Here, again, we'll assume we start with 9,000 shares, a stock price of $75 a share, starting yield of 6%, and 20 years to hold the investment. AbbVie shows solid growth in dividend payments, so we'll assume a 2% growth rate. Using this calculator, we find that after 20 years, our initial $675,000 holding has grown to $2,899,214.58. That is some substantial growth! The annual income increased from $36,000 to $41,000 in the first 12 months, but after 20 years, it's increased to $242,508. That could be a pretty high income, but again, these are rough estimates, and we don't know what will happen to inflation and so forth in the meantime. Remember that the U.S. government has amassed a huge debt, which could eventually cause major problems in the economy if it's not dealt with at some point between now and then.

Nonetheless, you need to take these lessons to heart. You can get a lot of growth from a solid dividend investment over time, and reinvesting the proceeds until you want to retire is a vital part of your strategy if maximum growth is one of your goals. When you do that and add to your investment by continuously buying more shares, you can end up with a very nice nest egg.

Of course, we note that some people might need the money right now, and that's why they are considering investing in a dividend stock. You can still benefit in that case, over time, the dividend payment may continue to grow, but if the company eventually stagnates, that may become an issue. You can also adopt a strategy of taking some of the cash and reinvesting a portion of the cash. For

example, if you're bringing in $3,000 a month, maybe taking $2,500 out as cash and reinvesting $500 a month is something that would work out for you.

Another consideration is the time that you're planning to hold the investment and use it to generate income. If you are only going to have it for 5 years or even 10 years, maybe reinvesting in it isn't a good idea and your needs for the immediate cash are more important.

Many of the issues that arise from investing in a single stock can be mitigated by diversification or possibly even better by investing in dividend ETFs. That way, you aren't subject to having your outcomes determined by the fate of a single company and can invest to assure future growth no matter what happens.

If you are not planning on retiring soon and have an adequate income from other sources, you should reinvest your dividend payments by purchasing more shares of stock.

Dollar Cost Averaging

Dollar cost averaging is an investment strategy that seeks to average out the volatility that comes with changing stock prices. So, if you are looking to invest in a stock that is currently priced at $75, it might go down to $70 at times, and it might rise to $80 at others. The same holds true for an index fund. If you have a fund that tracks the S&P 500, there are going to be lots of ups and downs over the short term. A jobs report or bad GDP growth report can cause the value to drop substantially. On the other hand, if the GDP growth report is better than expected, share prices might rise.

Your goal, in general, is to buy low and sell high, as they say, but it's hard to know when you are really buying low. It's a guesstimate as to when the bottom will be reached when stock prices are declining.

What dollar cost averaging does is it removes the guessing game by purchasing shares of stock at regular intervals no matter what the share price happens to be at that moment. At times, you are going to be paying a higher price for the stock. So using our example, if the short-term (meaning over a year or so) price of Abbvie fluctuated between $70 and $80, sometimes, you'd be buying at

$80, but at others, you'd be buying at $70. So, the prices that you'd be paying for your shares would be evening out (averaging) with time. This is a set-it and forget-it strategy and you won't have to sit there paying attention and agonizing over the share price. You just set a rule, say buy $500 worth of shares on the 10th of each month, and stick to it, knowing that, over time, the fluctuations in the price you're seeing are going to average out to the overall trend in the stock price (which of course may be rising). The more purchase dates you set, the better this process will work. Purchasing once a month might be a crude estimation, so you could break up your purchases into once a week, buying 1 or 2 shares every Friday instead of buying 6 shares one time per month, for example.

If you choose to adopt dollar cost averaging as one of your investment strategies, you need to be disciplined and stick to it. If you haven't used it before, you might have a lump in your throat when you are purchasing shares at a higher price, worrying that the stock price might drop and you feel like you're missing out on a good deal that may happen. But it may not and none of us can tell the future. That is why dollar cost averaging is a good technique to have in your investment toolbox.

Diversification

Any long-term investor should have a diversified portfolio. One of the problems with stock market investing is that people can get overcome by emotion that can cloud their judgment. It can happen no matter what kind of investor you are. For day traders, they can panic when a stock starts dropping fast leading them to sell before they should, or they might get greedy if they see it rising, and end up holding onto their stocks too long.

But you need to realize that emotional issues clouding judgment when it comes to stock market investing are not something that is limited to day traders by any means. Many times, long-term investors can get rattled by market ups and downs and make many bad decisions as a result. If you are a long-term investor, then you should ignore the fluctuations in the market, including recessions. Remember that recessions are temporary. For some reason, people tend to have a viewpoint that when a recession comes and stock prices drop that their wealth tied up in stocks was "wiped out". People will even say this after a recession ends and stock prices are

rising again. In the vast majority of cases, the wealth represented by the asset value of your stock holdings is going to recover and do it relatively quickly after a recession bottoms out.

The important thing about recessions and even run of the mill bear markets is that, in reality, these are buying opportunities. You shouldn't be holding out for a bear market, however, it might be a while before one shows up on your doorstep. But if you are using dollar cost averaging, at the very least, you should continue using your regular purchase schedule as stocks are declining. In fact, if you have the available capital, you should actually increase your level of stock purchasing during a downturn.

Here's the rub, when there is a downturn, nobody knows how far it will go. Day traders and other speculators might be looking for supposed "signals" in the data that indicate a turning mood among investors, telling them that a buying frenzy is about to erupt. This isn't to say the tools used in technical analysis of stock trends are not useful, they are, but you should take them with a little grain of salt. It's very easy to get misled by a short-term increase in buying or selling, and while people try to mitigate that possibility by relying on multiple tools, the reality is that's a very difficult problem to overcome and nobody can be sure they are right about what's going to happen next. In a mathematical sense, while human behavior can be predicted a large fraction of the time – think about how often it completely and utterly surprises you. That same unpredictability is operating in the stock market too, remember that, ultimately, it's the people that are behind decisions to buy or sell a stock. So, in the end, nobody knows when there is going to be a genuine market shift or not. But by using dollar cost averaging (and accelerating your purchases until prices start rising again), you can help take some of your emotion out of it and keep making purchases when the stock is a good buy.

Another problem with stock market investing is when people fall in love with a particular product or company. This happens all the time, and humans seem to be primed to fall victim to this malady. Many times, people develop an infatuation toward a given company. Apple is one historical example of this, where people have become so slavishly devoted to the company that it can do virtually anything and they will be lining up with their credit cards

out to buy whatever product the company spits out. Now, over much of the time, this was fairly justified. Apple was cranking out game-changing products ever since the iPod was developed. However, even after Steve Jobs passed away and the company began a slide into the world of the mundane with only incremental changes, the devotion of many "fanbois" continued where Apple was concerned.

Becoming infatuated with a company often has a rational basis, but it can also be something that is extremely destructive. The recent controversy around medical device maker Theranos is a case in point. If you get right down to it, the bottom line for Theranos is that the company is/was a complete fraud. That isn't to say everyone who worked at the company was a fraud, but the CEO was definitely a fraud. Even when this was crystal clear, many investors had become infatuated with the CEO (Elizabeth Holmes) - who was a very intelligent young blonde woman who tried to emulate the Steve Jobs vibe by wearing black turtle neck sweaters and dropping out of school. Unfortunately, being very intelligent isn't a guarantee that someone isn't mentally ill, a con-artist, or who knows what. It's possible that things simply got out of control. Holmes came up with some ideas for medical testing devices, and this got the attention of several heavyweight backers. Soon enough, the devices were being tested and used by large companies like Walgreens. But it was gradually revealed that the devices didn't work as claimed. It may be the case that Holmes started out with good intentions but got pressured to fake it when there was so much weight on her shoulders and huge pressure to produce a winner, and it was becoming known to her that it wasn't going to work. Or she may have been a fraud from the very beginning, we may never know. However, she has been charged with massive fraud by the Securities and Exchange Commission, so more information about this may be forthcoming.

In the case of Theranos, it's pretty clear that investors and large backers – who included political heavyweights Henry Kissinger, George Schultz, and billionaire and Secretary of Education Betsy DeVos – were so infatuated that they let their judgment get completely clouded. None of them have indicated why they were so taken by the company and its founder, but if you read some of the original patents filed by the company, the fraud should have been

obvious from the beginning. They sounded like “Star Trek” inventions, and the burden of proof for accepting they could work should have been very high. This is definitely a case where due diligence should have played a central role in any decision-making, even in the case of Walgreens that partnered very early with Theranos, probably seeing dollar signs as people would be going to Walgreens for many medical tests as opposed to laboratories that their doctors send to them now. But instead, people were easily taken by Holmes and the claims the company was making.

Theranos is an extreme example, but many investors get smitten with a wide range of companies and believe that the company is the next “sure thing”. Unfortunately, it’s a lot easier to see a “sure thing” when looking back on it. For example, Amazon was certainly a good bet to make in the late 1990s. But who would have really known how things would have turned out? At that time, Amazon was competing with quite mature and well-established companies like Borders Books and Barnes & Noble, not too mention a nationwide network of independent and small book stores that drove a huge fraction of traffic when it came to selling books. Nobody could have possibly foreseen that Borders would soon completely collapse and those small bookstores throughout the country would be nearly completely wiped out. Also, nobody would have been able to imagine that Barnes & Noble would be too slow to respond and be inadequate with their response. They are still around but are a shadow of what they once were.

Another thing that few people could have imagined was that Amazon would be extremely aggressive in their drive to expand into other areas, not only completely taking retail but getting into areas like cloud computing. That said, wouldn’t it have been great if you had bought a few thousand shares of Amazon in 1998 and just held onto them?

By the way – Amazon doesn’t pay dividends. Maybe they will at some point in the future, but given the incredible drive Bezos has, he is now looking at going into space, it’s hard to imagine the company becoming a dividend investment any time soon.

So, we can come to the central lesson of this section. Let’s pull all this together. The first point is we shouldn’t be the type that panics, letting short-term losses that will pass in a year or two govern our

decisions about holding stock. There are times that you'll want to sell a stock, but that would be when a company was failing, not just because there is a temporary economic slowdown.

The second lesson is that you should never let infatuation with one company, or a product that it makes, govern your investment decisions or the role that they play in your portfolio. Yes, it can't hurt to invest in some companies that you are excited about that have potentially disruptive products. However, you'll need to recognize that many times, your "bets" are going to end up dead wrong. Sometimes, they will be right, of course, but ahead of time, it can be quite difficult knowing which is which.

This brings us to the lesson of diversification. Any long-term investor should be using a diversification strategy and not putting all their eggs in one basket. At the very least, your fate should not be tied to a single company. If you had put all your investment capital into Theranos, you'd be broke today. If you had put it into Apple, you might be a millionaire. There were reasons in 2007 or 2008 to put a lot of money into Apple, but Theranos obviously made a persuasive case as well. When it comes to investments, letting everything ride on one company is a serious misallocation of your judgment and your money.

So, what does diversification mean, really? At a minimum, you should be investing in 10 different companies. That is probably the lowest level of diversification that should be considered.

However, you should not invest in more than 15-20 companies. The reason is that you should be devoting a lot of energy to your due diligence. This means studying the markets, knowing what the economy is doing, when the Fed is going to increase or decrease interest rates and what that might mean for each of your investments. It also means following politics, decisions by politicians might have implications for your stock holdings.

All those things apply whether you have one stock in your portfolio or whether it's 100. However, you also need to keep a very close eye on each company you invest in. You need to be aware of who the management team is. What are their backgrounds and how have they performed in the past? You need to be aware of the company making important changes to the management team.

You'll also need to study the company. When it was founded, what industry it's in, how it's performing, and what its future plans are. Is it heavily invested in R & D? Hoping to enter foreign markets? Taking steps to address problems? These are all important issues that should be addressed if you are going to be putting your life savings behind a company.

If you are doing this research properly, then it is unlikely you're going to have time to closely track more than 20 companies effectively. So, if you are planning on investing in individual companies, plan on choosing 15-20 companies.

Diversification doesn't end there, however. You should also be looking at investing in multiple industries or sectors. Something might happen that could hit one sector but not others. For example, at the time I am writing this, many politicians are jumping on the regulate-the-tech-sector bandwagon. This can have major implications for tech companies that collect data, like Facebook, Google, and Amazon. Depending on how far our brilliant politicians go, the impact could be devastating.

Even so, this may not impact other sectors like banking, agriculture, or healthcare.

So, you will want to look at all the major sectors you can invest in, and allocate some of your investment capital in different sectors. That way, if one sector gets hit particularly hard if the others don't, then your overall investment portfolio will remain viable.

Diversification can also be taken in other directions. Another way that you can diversify is to invest in companies that are based in other countries. You may want to invest in Japanese, Canadian, European, and Chinese companies. Or you might want to target some investments to emerging markets like Brazil. There are many issues that can come up with this, so a great deal of care is required. Take your amount of due diligence and triple it.

Normally, financial advisors also urge people to allocate their investments in different ways depending on age and also investment goals. So, the older you get, the more you should put your money into safer investments, which for them, involves putting money into bonds, money market funds, and maybe safe instruments like bank

CDs. As a dividend investor, you can also follow that procedure but you may also be avoiding it since dividend investing is a relatively safe way to invest that provides an income (something you'd be looking for if you were investing in bonds, say).

Now, within the world of dividend investing, there are many options you can use to diversify your portfolio that goes well beyond simply choosing a wide variety of companies to invest in across different sectors. For example, you can invest in exchange-traded funds, something we will discuss in the next chapter. Or you can invest in REITs. There are many ways to stay completely focused on dividend investing while pursuing multiple paths. So, for example, you could build up a portfolio that was allocated in such a way that 50% of your capital went to individual companies that you selected, 25% was in REITs and MLPs, and 25% went to exchange-traded funds.

The possibilities are nearly endless. Some investors might be using investments in dividend companies as a part of a larger, overall strategy. So, you could combine dividend investing with an aggressive growth strategy to drive more capital accumulation.

The point is diversification doesn't just mean investing in 10, 20, or 30 different companies. There are many ways to diversify your investments, but the fundamental truth behind all of them is that you're looking for a way to mitigate risk.

Since we are a big believer in taking advantage of downturns as investment possibilities, the risk that you're trying to mitigate is that you don't want to have one company take you down with them. In 2007, it would have been a really bad deal if you had put everything into Bear Sterns. While we can argue that if you were closely following the situation, a sell signal was flashing red, who could have really blamed you for investing in it? Before it started crashing, it was trading at $170 a share. It had been founded in 1923 and survived the Great Depression. It could have been seen as a good investment.

Rebalancing

Rebalancing is a process of buying and selling shares once a year to get your portfolio back to a place where you are satisfying your

long-term investment goals. Each year, it's inevitable that some stocks are going to increase more than others, and by the end of the year, the amount of capital invested in each company isn't going to match what you had planned for your long-term future.

For simplicity, let's say that you have 25% in banking sector companies, 25% in retail, 25% in healthcare, and 25% in high tech companies. At the end of the year, you might find that the shares in the high tech companies significantly outperformed the others, so you might end up with a portfolio with a capital allocation where there is 30% in banking, 15% in retail, 15% in healthcare, and 40% in high tech. If you decide at the end of the year that you are committed to sticking to your original plan, then you're going to sell 5% of your investment in banking sector companies and 15% of your investment in technology sector companies, and then reinvest in the sectors that dropped in proportion. So, you'd buy shares in retail and healthcare until all your investment sectors had 25% each.

Selling off the shares and buying new ones in this manner helps you "rebalance" your portfolio. It will also help you book profits by selling shares that were in the sectors that saw growth, you take your profits and reinvest them.

This is an important strategy if your asset allocation has been designed to help you reach certain goals, such as value, growth, or income.

Another way you can look at using rebalancing, when we are specifically considering dividend investing, is to put more of your money into companies that pay higher dividends. After all, the goal for dividend investors is to have shares that pay back a return beyond simple stock appreciation. So, if you have a company that pays smaller dividends but whose shares significantly increase in price over a year, you can sell those shares and take the profits, and then invest those profits into a company that is paying a good dividend.

Let's say that your portfolio consisted of just three stocks. Apple, IBM, and AbbvVie. Remember that the dividends paid by these companies are about $2.61, $6, and $4, respectively. Suppose that you have 1,000 shares of each, but then Apple shocks everyone by

releasing a new phone, and their share price jumps by a large amount. Even then, although the dividend might increase, it's probably unlikely to reach the level that IBM is at, and even AbbVie. So, you could sell a fraction of your Apple shares, and then use the profits to buy more shares in IBM and AbbVie.

DRIPS

If you haven't heard of DRIPS before, as a dividend investor, you should learn what they are and determine whether or not you're going to want to use them if they are available for the stocks you invest in. A DRIP is a Dividend Re-Investment Plan. A DRIP will automatically take your cash dividends and buy new shares of the stock with the proceeds. It may also allow you to buy fractional shares so that all of your money is invested. DRIPS may come with a fee, but many leading companies that pay dividends offer no-fee DRIPS. These companies include AbbVie, Exxon, Johnson & Johnson, and Aflec among others.

If you are in your investment plan for the long haul and aren't looking to take cash out right now, using DRIPs can be a way to enforce discipline. If you receive the cash payments, you might be tempted to spend it. In this case, signing up for a DRIP plan will ensure that the money goes straight back into the purchase of new shares. Reinvesting is a key component of growing the size of your portfolio over time.

However, DRIPs aren't for everyone. If you are planning to use your investments to take cash out now, that is, you're doing this for immediate income, then you're not going to want to use a dividend reinvestment plan. The reason is your dividends will be reinvested into the stock automatically. So, you wouldn't receive any cash payments from that stock.

Another person that might not want to use DRIPS is someone who wants to reinvest the money from their dividends, but they might be planning on investing that money into other stocks. If you sign up for a dividend reinvestment plan, you are giving control over the dividends to the company, which will automatically buy more shares in their company on your behalf. If you want to invest elsewhere, then don't use a DRIP, and instead, take the cash payments, and then you can reinvest it as you see fit.

If you don't use a DRIP, you also have the advantage of splitting up the money, you might want to take some in cash either to spend or to invest elsewhere, but reinvest part of your dividend money in the company. If you retain control over your investments and don't sign up for one of these plans, then you'll be able to do what you want to do with the money.

Dividend reinvestment plans can definitely work for you if you are at a point in your life where you don't yet want to take the cash out from the dividends. A DRIP will help you enforce discipline, and it will enable you to automatically take advantage of the compound interest nature of reinvesting your dividends back into the stock and growing your assets in the process. It will also help build time into the equation since time + interest = huge money.

Consider that each time you buy a new share of stock, you will begin earning money off that new share the next time there is a dividend payment. Keeping things as simple as possible, suppose we had one share of stock in a company that paid $10 a share in dividends and it's trading at $10 a share. The first time we get a payment, we get $10. You could take the $10 and go out and buy a pizza!

Or instead, you could use the $10 to buy another share of stock. Now, you have two shares, so the next time there is a dividend payment, you get $20. What to do at this point? Well, you're facing the same conundrum, and maybe, you'll buy two pizzas. Or you could reinvest with $20, having purchased the extra share of stock last time around means that you can buy two shares this time.

So, now you're up to four shares of stock. Another dividend payment comes and you get $40, and you can buy four more shares of stock, doubling your total investment holdings.

You can see where this is going.

It's possible to have a DRIP with your brokerage or directly with the company. Typically, there aren't fees associated with the transaction, but if you invest directly with the company, they may offer some discounts on your stock purchases. In other words, you may be able to get some shares at prices that are lower than the current trading price of the stock.

Before we leave the topic of DRIPS, let's go over the arguments against them. We've already discussed the first argument, and that is the income argument. If you are in dividend stocks because you need the income now, then a DRIP is not going to be something that would work out for you.

A second reason to consider avoiding DRIPS is that if you are using rebalancing in your portfolio, the automatic reinvestment of the DRIP might cut into your plans. Each quarter, you're going to automatically own more shares of any stock that is part of a dividend reinvestment plan. Growing shares in those particular stocks may not align with your overall investment goals. Also, it makes it harder to purchase shares from other companies, since the cash you could have taken out will be automatically reinvested.

Another reason that you might not want to have a DRIP is that when dividends are paid, it's going to buy shares on your behalf automatically. So, you'll be forced to buy shares no matter what, even if the price isn't favorable. You might be at a market peak, and if you have a DRIP, well, that's life. Of course, if you are using dollar cost averaging, that will mitigate this to a degree. Remember that dividends are typically paid on a quarterly basis, and so, you'll have dividend reinvestment purchases of shares that will happen four different times a year. And they will more than likely be able to take advantage of different pricing for the shares.

The bottom line with DRIPs is if you are early in your investment life, and you've begun putting money in a solid dividend stock, then having a DRIP makes sense. The fact that your proceeds are going to be automatically reinvested will make sure that your own personal foibles and emotions are not getting in the way of strict market discipline. You can always turn a DRIP off at a later date. There are also other ways to rebalance your portfolio as well, so that excuse might not be good enough when it comes to deciding that you are going to avoid having a DRIP.

On the other hand, if immediate income is your goal, then a DRIP is probably not something you'll want to pursue.

When to Sell Dividend Stocks

There are many reasons that you might find yourself in a position

where you want to sell a dividend stock. But before we get into those specifics, we want to make sure that you remember the ex-dividend date and its importance. If you sell the stock before the ex-dividend date, even if it's the day before, then you will lose out on the dividend payment. Whoever owns the stock on or before the ex-dividend date is the person who gets the payment. So, if you decide to sell a dividend stock unless there is a compelling reason you should hold off until the ex-dividend date has passed. That way, you will get the last dividend payment associated with your stock ownership.

Something else to note about selling dividend stocks is that when the ex-dividend date goes by, it's typical that the share price is going to drop by the amount of the dividend. This is because, in the eyes of investors who are looking to buy shares in the company, the shares have lost a little value (the amount they would have gotten from the dividend). Imagine that a stock is trading at $100 and it pays a dividend of $2 a share. People looking to buy the stock before the ex-dividend date may have many reasons to buy the stock, but one of them is definitely getting that $2 per share payment. Once the payment is made, and they have to wait another quarter, then the stock isn't worth quite as much and so it drops by the $2 they missed out on, and will now be at $98 a share. Over time, it's going to regain that lost value, but don't be under the illusion that you can pocket the $2 dividend letting the ex-dividend date pass and then simply sell the stock for the original share price of $100.

Of course, there is a risk that the share price is going to lose value for other reasons if you hold the stock too long.

There can be many reasons to sell your shares. For one, you might need to rebalance your portfolio. So, you'll want to sell off some shares if the current holding has grown out of proportion to where you want it to be.

Another reason to sell a dividend stock is maybe you've found a stock that pays a better dividend. The stock market is always dynamic if it's anything, and so there is always the possibility that while you thought your original stock was very attractive, you find later that there is another stock that pays a higher dividend and the company has solid fundamentals.

The reliability of a dividend payment is an important consideration as well. First off, is the dividend payment growing with time, or at least staying the same? Hopefully, it's growing. You're going to want your dividend income to beat inflation. Also, a growing dividend is a part of the indication that the company is growing, and with more net income, they are happy to share more money with investors. On the other hand, if the dividend isn't reliable, it's growing smaller, for example, or changing erratically, that is a bad sign for a dividend investor. In that case, you might want to bail on the stock before things get worse.

That's one reason that AbbVie is so attractive, they've steadily paid dividends and the size of the dividend steadily increases. They even increased their dividends when the stock price had dropped.

Something else you'll need to keep a close eye on is the financial health of the company. You will also want to keep an eye on its bond rating, even if you aren't buying bonds from them. If their bond rating drops, the company may be late or missing payments – an indicator of trouble. Look at the cash flow of the company and read all the financial statements. If the company is showing signs of deterioration or trouble ahead, by less cash flow, then you're probably going to be better off opening yourself up to finding a better, more solid investment.

A company that starts taking on large amounts of debt might be in trouble as well. Of course, there are legitimate reasons for a company to take on debt. So, you might see your dividend payments shrinking as the company gets bogged down in making interest payments on its debt, or simply has a problem managing money in general.

Crashing stock prices paired with higher yields can be a problem as well. That is something you'll see with Consolidated Communications. They may be focused on keeping their historical dividend payment despite a load of financial problems elsewhere. Why would they do that? Because keeping the dividend payment at the same level - even though the share price is deteriorating –will help them attract investors. The lesson here is to always do your analysis. If a company's dividend payment is rising, find out what the reason is. If you find out that it's rising in order to keep the yield at a certain value, that could be a trick that's being utilized to

pull people in, and you'll want to stay away.

Besides taking on a large amount of debt or a crash in the share price, another thing to look at is the stock buybacks. If a company can't buy back stock or has significantly backed off from stock buybacks, this might be a clue that they are going to be heading for trouble. They may not have enough cash on hand to meet obligations, and so, their ability to pay dividends may be compromised.

These factors indicate that investing blindly is not an option. Remember, you need to be looking at the company's financial statements so you have a clear idea of where they have been and where they are going, you need to read the company's website and any publications so that you know what their big plans are to stay profitable or regain profitability, and you need to be ready to cut ties when it becomes clear that a company is no longer a good investment.

Bear Market Opportunity

As we said earlier, when there is a bear market, let the fools follow the lemmings over a cliff. Crashing stock prices are an opportunity to pick up a lot of shares at discount prices. If there is one thing that can be guaranteed, a bear market is going to be followed by a rise in prices. Even the Great Depression began seeing large increases in stock value from 1933 onwards.

For example, let's have a look at Bank of America stock over the period of April 2007 through April 2010. The stock dropped from $50.90 with a dividend payment of $0.56 a share in April 2007 to a share price of $3.14 a share on March 2, 2009. If you had bought 1,000 shares in April 2007, it would have cost you about $50,000. But if you had bought 1,000 shares in March of 2009, it would only have cost you around $3,140. And incidentally, that dividend payment had dropped to a penny a share in March of 2009. Today, the stock is trading at $27 a share, with a forward dividend of $0.15 per quarter. That isn't a good dividend and I wouldn't recommend buying the stock for the dividend, but if you had bought the shares at $3.14, you could sell them now for $27,000 and have made a profit of nearly $24,000. As we discussed earlier, Bank of America could be an investment to consider if you bought

the preferred stock. Of course, it is expensive on a per share basis.

The point is, recessions and bear markets are buying opportunities. Look at another stock, this time Johnson and Johnson. It dropped from $71 a share to $48 a share. Throughout the entire economic crisis, the dividend payments for Johnson and Johnson remained relatively constant and even raised a bit from $0.41 a share to $0.46 a share. That is a good sign of a solid company that can weather storms. Of course, Johnson & Johnson makes many things that people need for their day-to-day lives, and the 2008 recession being a banking crisis (in part anyway), it would have been more attractive at the time than Bank of America.

You should do your research now so that you are well prepared for the next bear market. Look for stocks that did not slash their dividend payments during the recession. That is a good sign of a stock you might want to be in over the long term. Remember, they always come, and no matter how prepared we are, the economy has its ups and downs. But rather than fear it, imagine how much better off you'll be if you start seeing bear markets as investment opportunities.

Dividend Aristocrats

A dividend aristocrat is a company that routinely raises its dividend payment. In fact, Standard & Poor maintains a listing of the top 50 companies called the dividend aristocrats. According to their specific criteria, a dividend aristocrat is a company that has raised its dividend at least one time per year over the past 25 years.

You can look up the list to see who these companies are and you could invest in each of these companies or pick a list of 20 of your favorites out of this list to make your own dividend aristocrats list. However, buying individual stocks yourself in this manner could be problematic. Companies move on and off the list all the time, especially during major economic downturns. Prior to the 2008 financial crash, many banks were on the list, and at the time, they were considered among the most solid investments around. But we all know what happened, and so, simply investing in companies on the list might have gotten you into some trouble.

While some companies were forced off the list, many held their

dividend payments steady right through the crisis and even increased them. You can study the data yourself and find some of these companies; they may or may not be a consideration for investment. Some of them actually pay a low rate per share but have higher yields.

The best way to invest in a group of companies like this is to find an exchange-traded fund that will do it for you. Unlike mutual funds, exchange-traded funds have minimal fees, and as we noted earlier, they trade just like stocks. One fund to consider is SDY which invests in many of these companies. SDY is yield weighted, and so gives more weight to companies that pay higher yields making them a larger proportionate share of the funds' investments. With a fund like this, the funds managers will decide what companies to invest in or sell, so you won't have to worry about it. As we mentioned earlier, it's trading at about $95 a share and paying $2.12 a share on an annual basis (it's actually paid out quarterly). The ETF has investments in AbbVie, A T & T, IBM, Cardinal Health, and Verizon Wireless, among other companies.

There are other good dividends ETFs available, however. One you should consider is the iShares Dow Jones Select Dividend Index Fund. The annualized dividend payment is $3.48 with a 3.67% yield. This ETF is trading at $94 a share. So, it's slightly less per share than SDY, but pays $3.48 per share as opposed to SDY paying $2.12 a share. If you can make more money for a slightly smaller investment, that sounds worth considering. The goal of the fund is the same. It's looking for stocks with consistently growing dividends. Some of the holdings of this fund include Microsoft, Apple, JP Morgan Chase, Johnson & Johnson, Coca-Cola, Verizon, and Chevron. Of course, it also includes AbbVie.

Chapter 4:
High Yield Investments

In this chapter, we are going to look at some of the more unconventional ways you can invest in dividends, the high yield investments. We have touched on these a little bit in the first chapters, these include real estate trusts or REITs, master limited partnerships or MLPs, and BDCs. Each of these has their advantage and disadvantage, so let's have a look at them and see whether or not they are something that you might want to include in your investments.

REITS

A REIT is a real estate investment trust. There are two types of REITs. The most common type is an equity REIT, which invests in properties. It makes money by collecting rent and selling properties. The second type is called a mortgage REIT, and it makes loans, earning profits from the interest paid with the loan. When dividend investors buy shares in a REIT the vast majority of the time, they are going to invest in an equity REIT.

Equity REIT is typically going to hold commercial properties, but they can hold multi-family properties as well. You can invest in REITs of different types, for example, one might invest in office buildings while another may hold retail or industrial properties.

A REIT makes getting into real estate investing rather easy. They trade like stocks and are relatively inexpensive. Look for share prices around $100 a share.

A good example of this is Digital Realty Trust (stock ticker DLR). Looking this up on Yahoo Finance, we see that (at the time of writing), it's trading at $115 a share. The forward dividend yield is a healthy 3.67%, and the dividend is $4.32, which is a very attractive payment. This is an attractive REIT to invest in because it's a digital data center REIT. So, they own facilities that are used for cloud computing. There is no doubt that this will be in demand in the coming years.

Welltower is a healthcare-oriented REIT, investing in everything from hospitals to old-age homes (stock ticker WELL). The share price is $82, and it has a yield of 4.67% and a dividend payment of

$3.48 per share.

If you are noticing, REITs have pretty healthy dividend payments. You might be better off investing in DLR than Apple if your goal is a higher level of income. DLR costs less per share, so the barrier to entry is lower and yet it pays around $2 above what Apple is paying for the dividend.

REITs exist for virtually every type of property. Consider Gladstone (LAND), which buys up and rents out farmland. AMH (American Homes 4 Rent) is a REIT that invests in single-family homes which it rents out. It's trading at $24 a share. That one does have a low yield and dividend (0.83% and $0.26, respectively), so you might want to hold off on that one for now, but we mention it to illustrate that there are a wide variety of choices when investing in REITs. Other REITs even own such obscure things as cellphone towers.

If there is one thing virtually everyone has discussed investing in at one time or another, it's probably real estate. However, if you were to invest in real estate, you have to get loans or spend a large amount of money. Let's compare investing in a REIT to buying a house and renting it out.

First, let's look at renting a house. Suppose you bought a home for $250,000, say in Denver, Colorado or Salt Lake City. We want to pick a midsized to large Western city to avoid getting caught up in worrying about out of control sky-high rents in places like San Francisco, Los Angeles, or New York City. The best case scenario is you pay cash. A home in that price range might rent for around $1,400 a month. On top of this, there are property taxes, but we'll assume that the tenant covers the over expenses. Taking property taxes and any incidental expenses into account, which in western cities that aren't super crowded aren't too high; let's say that you profit $1,100 per month. At that price, it would take you 228 months to make the $250k back. That's 19 years. Basically, during that time, you make zero profit.

If you put $25,000 down and took out a loan for the rest, a 15-year mortgage would cost you around $1,655 a month. That might not cut it in your market, so you could eat the difference in what rent was being paid, or you could opt for a conventional 30-year mortgage. In that case, with 3.92% interest, your mortgage

payment would be $1,092. So basically, you're breaking even, but the tenant is paying the mortgage.

If you invest $250,000 in DLR instead, you're going to get dividend payments of around $8,700 a year. While the $250,000 is locked into the investment, there is no mortgage. If you wanted to, you can reinvest the money from dividends and buy an additional 75 or more shares per year and take advantage of compound interest to grow your principal over time.

At this point, it might be a matter of taste which you prefer, but what REITs allow you to do is get in properties without the hassle of having to actually own properties. You can invest in actual real estate by buying a few houses if you have the cash or the credit. But you're going to be dealing with tenants, having to pay for the upkeep of the properties, periodically having to remodel the homes or at least putting in new flooring and updating bathrooms. It's not as simple as it looks from the outside. With REIT investments, you can get into diversified types of real estate while other people handle all the hassles, and getting out of it is as simple as putting in a sell order with your broker.

REITs are entities that don't pay corporate taxes, and they distribute most of their earnings to the shareholders. Typically, they pay out 90% of their earnings. Before buying into a REIT, you're going to want to look under the hood just like you would before investing in a company. What you're going to want to know is how their income is being generated. With REITs, you're going to look for Fund from Operations which is also listed as FFO. The types of things that go into calculating FFO include net income, depreciation, interest income, and gains or losses from selling properties. REITs will also have an adjusted FFO, which adjusts the FFO by taking into account some other items that are subtracted from the FFO calculation. These can include money spent on maintenance of the properties, rent, and unrealized gains.

Some REITs might calculate their FFO differently than others, but you can use the ratio of Share price to FFO. The higher the value, the better.

As with stocks, you're going to want to look at the performance over time, and in particular, their cash flow. You will also look at

yield and dividend payment to see if that is something which will fit into the ranges of dividend payments that you are willing to accept. If the FFO has a solid growth rate over several years, it's a good REIT to invest in.

Like every other kind of investment these days, you can use an exchange-traded fund to invest in REITs. This has several advantages. The first is diversity in the types of exposure. That is, instead of buying one REIT yourself that is focused on one type of property, you can invest in an ETF that is invested in dozens or hundreds of REITs. They are also going to be invested in many different types of REITs, so you can get exposure to hospitals, land, digital, home rentals, and so on.

IYR is a real estate REIT ETF provided by iShares. It invests in companies that are on the Dow Jones Real Estate Investment Index. Another famous and well-regarded REIT ETF is Vanguard VNQ. You can get on the websites to see how these have performed. According to iShares, if you had invested $10,000 in IYR 20 years ago, today, you'd have $50,000 in equity. Of course, this doesn't take into account the money made (and possibly reinvested) from dividends.

REITs can be an interesting investment to add to your portfolio, but be aware that they do carry some risks. The biggest risk is interest rate risk. Being in real estate, REITs may be taking out a lot of loans. Higher interest rates may mean higher expenses for the REIT, but there are other factors you will have to take into consideration, such as the context of the higher interest rates and what's happening in the economy at large. Depending on circumstances, higher interest rates may mean more competition for properties (especially commercial properties) that could mean higher profits for the REIT. In any case, a REIT should be taken to be a long-term investment, so the usual buy-and-hold strategy applies here unless you have compelling reasons to put your money elsewhere.

MLP

Now, we turn our attention to MLPs, which are master limited partnerships. As we noted in the introductory chapter, this is a business which is a partnership that is traded publicly like a stock. MLPs trade on major exchanges. However, it acts as a partnership, so profits will be taxed when investors receive the distributions. An

MLP is required to distribute the cash it has on hand to investors. It has general partners and limited partners, as an investor, you will be a limited partner. You are not involved in any way in the day-to-day operations of an MLP.

The law requires that an MLP has to pass 90% of its income to investors. Congress restricted MLPs to certain sectors because they are upset that MLPs don't pay corporate income taxes but are publicly traded. As a result, MLPs are limited to real estate, energy, and finance. Since most real estate operations are REITs, the vast majority of MLPs are in the energy sector. Oil and gas operations are something you'll find in MLPs. Usually, this is in transportation or infrastructure company so it will transport oil, own refinement facilities, or oil pipelines. They are not as sensitive to oil and gas prices as a direct energy company like Exxon, because they are paid by the volume of oil or gas they can transport.

An MLP is a tax-advantaged to the investor, which means you can offset your tax bill quite a bit. Depreciation and depletion are actually passed along to you, as the investor and you handle that on your own taxes, which can result in very substantial tax savings. This happens because as a partner, you have a stake in the assets of the company so can take advantage of the depreciation. Note that if you invest in an MLP ETF, you don't get these tax advantages.

Although you should probably not get involved in investing in an MLP ETF, it's easy to invest in MLPs because they trade like regular stocks on major exchanges. However, they are bought and sold in "units" rather than shares. They act like dividend stocks, but the income paid from MLPs is called a distribution rather than a dividend, and it's paid quarterly. Income from distributions is treated as a return on capital for tax purposes. This means that the majority of your distributions from the MLP are not taxed until you sell your shares (units). You could avoid the tax by simply not selling; otherwise, you can sell them and pay capital gains taxes. Yields from MLPs tend to be very attractive.

For example, Enterprise Product Partners (EPD), which owns oil pipelines, offers a yield of 6.11% with a distribution of $1.75 (paid quarterly, annual amount). The price per unit (aka price per share) is about $25. Magellan midstream partners (MMP) is trading at $62, with a yield of 6.54% and a distribution of $4.02. Incidentally,

“midstream” is energy jargon for a company that transports energy. “Upstream” would be the actual drillers.

Since the tax advantages are lost if you buy into an MLP ETF, you’re better off investing in the MLPs themselves. One thing we can be sure of is that energy isn’t going anywhere anytime soon, even if Alexandria Ocasio Cortez thinks it’s going to be completely transformed in 12 years. You can bet that she is wrong about that and these are good investments.

You’ll want to investigate the financials for any MLP you consider investing in. There are three items of interest. The first is the amount of cash distributed by the MLP to the partners (investors). Second, you should know the DCF which is given by DCF (Distributable Cash Flow). This is basically the cash left over after expenses and paying the general partner. This will include net income, depreciation, and capital expenses like maintenance of the pipelines or building new ones, etc.

Once you know DCF, you’ll also want to know the coverage ratio or CR, which is DCF divided by the cash distributed to the unit holders. What this tells us is how healthy the MLP is as far as being able to make the cash distributions to unit holders. If the coverage ratio is less than 1.0, that means the MLP wasn’t able to make its payments to the shareholders. So, probably one you’ll want to avoid. Before investing, check the coverage ratio.

Since you aren’t going to be using an ETF because of the tax implications, if you want to invest in MLPs, you should handle your own diversification. You should invest in about 5-10 MLPs. Pick MLPs with high yields and coverage ratios that are above 1.0.

BDCs

A BDC is an investment company. The formal name is Business Development Company, and it generally invests in small to mid-sized businesses. Business Development Companies typically target young companies that are in need of capital in order to grow. These are typically companies that can’t obtain funding elsewhere.

Congress set up the BDC as a structure in 1980. If the company meets certain requirements as set by law, such as paying out the minimum required amount of cash flow to investors, it can be

structured as a BDC and avoid paying corporate income taxes. So, a BDC essentially acts as a pass-through company. Many of them pass as much as 98% of their income to investors, which can result in very high yields.

In practice, BDCs can act like venture capital firms, investing cash for equity into small and medium-sized businesses that are growing. At other times, a BDC will provide loans to businesses. Sometimes, the BDC acts as a salvage operation, investing in or lending money to a business that is in distress, for the purpose of turning its fortunes around.

Typical yields for BDCs range between 8-12%.

An example of a BDC which provides investment capital to help distressed companies turn around is Saratoga Investment Corporation (ticker SAR). Investments can be up to $20 million.

Many BDCs offer secured loans to small and medium-sized businesses. An example BDC that does this is Apollo Investment Corp (AINV). A company like this is considered a solid investment. Since it's giving out loans, it earns a steady stream of income in the form of the interest payments.

Chapter 5:
Using Options for Income

Dividends aren't the only way to earn money off the shares of stock you own. You can also earn money writing options contracts if you're not averse to the higher level of risk. In truth, the risk is relatively low and you can derive a solid income from selling options contracts. What's more, you could combine options with your other means of investing to increase your income potential. For example, you could invest in a stock that paid a solid dividend and reinvests the dividends as time goes on. But you could still make cash from the shares by writing covered call options on them. However, you have to be aware that there is a risk you would have to sell the shares. The real risk is relatively low for two reasons, however. The first is that few call options are actually exercised, and the second is that even if you're forced to sell your shares, you will still probably make a profit and can reinvest the proceeds from the sale in another stock.

What is a call option

A call option is an option to buy shares of stock at a fixed price. We call the fixed price the strike price. An option comes with an expiration date, and there is a wide range of expiration dates, but typically, they are going to expire in the near term like 3 weeks or a month. Underlying any options contract are shares of stock, and there are 100 shares of stock for each options contract.

Options contracts trade on exchanges that are set up specifically just for them, so there is an entire world of options traders living off the stock market. This works to your advantage. The reason is that most options traders are interested in profiting off the trading of the options contracts themselves, but they aren't really that interested in owning the shares of stock. But be aware that some people who buy options contracts are interested in buying the shares, so you may end up having to sell your shares in some circumstances. However, the data shows this doesn't happen most of the time, and so as we'll see, this provides an opportunity to earn a monthly income from your shares.

Pricing of Options

First, you should familiarize yourself with some options in the marketplace so that you know how they are priced and you can get an idea of how much money you can make off your shares. To write an options contract, you will need to own at least 100 shares of the underlying stock. The price of the option is going to vary on two things; it will vary on the price of the underlying stock itself, but remember that the option also has an expiration date. So, the price of the option is also going to be impacted by the expiration date. The closer you get to the expiration date, the lower the price of the option – all other things being equal. A few days out from the expiration date, the price of the option is no longer impacted by the time left until the option expires. We call the decline in price from the time until the option expires time decay, and the value that goes into the option from the amount of time left on the contract is called the extrinsic value.

The value of the option that comes from the underlying stock is called the intrinsic value. Ideally, the intrinsic value would come directly from the price of the underlying shares. Remember, there are 100 shares for an option contract, so a rise in the price of the underlying share price by $1 would mean a $100 rise in the price of the option. Similarly, a $1 drop in the share price would mean a drop in the price of the option by $100.

In the real world, the relationship isn't that cut and dry, but there is a number that you can look at in stock data that will give you a good estimate of how the price of the option will change with changes in the underlying share price. This is a Greek symbol called delta. It's a number that ranges between 0.0 and 1.0, so if Delta is 1.0, then the change in the price of the option will be ideal that is a $1 rise in share price will result in a $100 rise in the price of the option. If Delta was 0.7, then the price of the option would rise to $70 for every $1 rise in the price of the stock.

The idea of a call option is to give a bullish investor, that is someone who is expecting the stock price of some investment to rise in the near term, the ability to buy shares of stock at a cheaper price that is agreed upon beforehand. So say that you own 100 shares of a stock that is trading at $100. Maybe a bullish investor out there believes that the stock price is going to rise to $105 a share. But they want a bargain and they're only willing to pay $102

a share. So, they can buy a call option with that strike price. If at any time that the call option hasn't expired, the share price goes above $102 a share, that would mean that the buyer of the option could exercise their rights to buy the shares. And the seller of the shares would be obligated to sell them at the discounted price of $102.

Now, let's look at it from the seller's perspective. You may be bullish on the stock over the long term, but you may not believe it will pass $102 a share. Also, chances are you bought the stock back in the past for a lower price than it's currently trading at. Therefore, if you had to sell the shares at $102, you wouldn't be too bothered, since you would probably be making a profit anyway – even though that profit might be quite a bit lower than the profit that you would have made selling them at $105 a share. However, as we'll see in a second, some of that difference is going to be covered by the money you get by selling the option.

An option isn't free. Someone that wants one has to buy it. Prices are quoted on a per share basis. So, if you look up options prices, you will need to multiply the quoted price by 100 to get the price someone would actually have to pay. Let's look at our favorite dividend stock, Abbvie.

The share price at this instant is $75.70. There are call options with strikes above and below this share price. For a call option, when the market price of the share goes above the strike price for the call option, the price of the option goes up by a lot. Options with prices above the current share price are still worth money (until they expire), but the higher you go in strike price above the current market price, the lower the cost of the option.

So, we see a call option expiring in three weeks that has a strike price of $76.50, or $0.80 above the share price. It's estimated that there is a 69.7% chance of profit, meaning that before the option expires, the share price has a 69.7% chance of being lower than the strike price of $76.50. The price is quoted as $1.40.

So, if you owned 100 shares of Abbvie, you could sell this option for $1.40. Since the contract covers 100 shares, you can sell a contract on 100 shares for $1.40 x 100 = $140. If you own 1,000 shares, you can, therefore, sell ten contracts and earn $1,140. The

payment for an options contract is called the premium. So, the premium is money you earn off the stock, and odds are you will be able to take the money as profit and still keep your shares. But be aware there is a risk that if the stock price went up to $77 a share, which would put your price below the market price, you might have to sell your shares for $76.50.

You can reduce your risk by picking a call option with an even higher strike price, making it less likely that you'll have to sell your shares because the probability of the stock price reaching the strike price and exceeding it gets smaller with each higher strike price you consider. Remember, options expire, with most of them expiring in the near term. That means it's likely the three or four weeks will pass and you'll still have your shares. Especially with a stock like Abbvie that isn't all that volatile.

So, let's suppose that the price did go to $77 and you had to sell your shares for $76.50. In fact, let's suppose it goes to $78.50 so that you would lose out on $2 a share. First of all, note that you probably aren't losing anything, what you are losing is potential profits. If you had purchased the shares in the past, say in June of 2017, you paid $67 a share for them. So, even though you can't sell them for $78.50, you're still selling them at a higher price than you paid for the shares. Plus the money earned from selling the options contract is yours to keep. So, you've made $1.40 per share from that, and so, you're nearly at the $78.50 price when you add all that up.

In the jargon of options traders, a call option is in the money if the market price of the stock goes above the strike price of the options contract.

If you are buying and selling shares looking for capital gains, then this scenario isn't going to bother you at all. However, if you are a dividend investor, you do have that risk staring at you that you will lose the shares and so be out the dividend.

But the fact is most options traders are looking to make profits buying and selling the options contracts themselves. Therefore, they are probably going to end up selling an options contract to someone else if the option goes in the money. Why would they do that rather than buying the shares? Because an options contract that is in the

money is worth more, and so they can sell it and take their profits.

Let's look at some prices of the money call options for AbbVie that expire on the same day. A $75 call is priced at $2.21, so it would sell for $221. A $73 call is priced at $3.58, so it would sell for $358. That would mean if you had 1,000 shares, you could sell 10 options contracts for $3,580. That isn't a bad passive monthly income.

Dividend Stocks aren't volatile

One of the good things about dividend stocks when it comes to this strategy is they don't tend to be volatile. A volatile stock that has wild price swings is more likely to exceed the strike price, which might cause you to have to sell your shares. Since most dividend stocks are slow and steady as they go, growing but doing so at a slower and steadier clip as opposed to say, Tesla, Netflix, and Amazon, you're less likely to face the prospect of having to sell your shares.

However, the risk that you will have to do so is real, and sometimes, it will happen. So, be sure to pick a strike price that you are willing to live with, so if you are not comfortable selling the shares at $76.50, pick $77 or whatever suits you. Just remember the higher the strike price the less money you're going to earn.

The further out you go, the more money you make

Calls that expire months in the future can be sold for high premiums. Looking out six months for AbbVie, we see that a $77.50 call sells for $4.73 per share, so 100 shares per option mean we could sell one option contract for $473. If we owned 1,000 shares, then we could sell 10 contracts for $4,730.

You can go even further out in time. If an option expires more than nine months into the future, it's considered a LEAP. That stands for Long term Equity Anticipation Security. For AbbVie, we can check a year and a half into the future and see that a $70 call is selling for $11.28, so the price of the options contract is 100 x $11.28 = $1,128. Just remember that the longer you have until option expiration, the more chance there is that someone might "call" the option and force you to sell your shares. So, you should choose a strike price that would be above the price you paid for the shares when you bought them.

Put Options

We can use put options to mitigate the risk of having to sell our shares with the covered call option, but first, let's get a little bit of familiarity with what put options are. A put option gives the buyer the option to buy shares of stock at a particular price. Like a call option, that price is called the strike price. One way that options traders use this to make money is they buy a put option for a stock that they think is going to go way down. Then, if the stock does go down, they buy 100 shares at the cheap market price, and then they exercise the option and sell them to the writer of the contract at the strike price. The profit is the difference between the strike price and the market price. Let's use an example.

Suppose that a stock is trading at $100 a share. You buy a put option with a strike price of $90 a share, but you don't own the stock. But you're basically shorting it; you would do this if you think the stock is in for a massive decline. Suppose that the option sold for $2, which would be a total price of $200.

Suppose that the stock does decline significantly before the expiration date of the option. For the sake of illustration, imagine that it drops to $40 a share. So you buy 100 shares for $40 x 100 = $4,000.

But since you own a put option with a $90 strike price, you can exercise it. That means you can sell the shares for $90 a share. So you make $90 x 100 = $9,000. Your profit is $5,000 from the sale of the shares. You also had to pay a premium for the put option, which was $200. So your total profit is $4,800.

Of course, the numbers are a bit absurd, but they were chosen to illustrate the point and show you how to put options work and why people might buy them.

Earlier in the book, we described how you could use a put option as a kind of insurance on your stock (in theory anyway).

Expiring Worthless

Now, if time runs out on the option and the strike price isn't in a favorable position, that means that the option expires worthless. For a call option, if the market price is below the strike price, the option

is worthless at expiration. That's because nobody would want to pay more per share (the strike price) than they could pay on the open market. So, they are not going to exercise the option under any circumstances.

For a put option, if the share price is above the strike price at expiration, then the option expires worthless. That's because the person who would exercise the option would be forced to sell them to you at a lower price than they could get in the market, and that doesn't make sense.

Selling in the money call options

So, we see one way that someone might profit from a decline in stock price, but there is a way you can profit from a decline in stock price using covered calls as well. This is done by selling a call that is already in the money. So, let's say that for the sake of argument, there is going to be bad news coming out in 3 weeks about AbbVie. Anticipating that the stock price will drop, and so make a call option that is out of the money worthless, you write a call option but one that is in the money now, so you can charge a higher premium. So, if the current market price is $75.70, you can sell a call option for $74 if you expect the share price to drop below that. The price for that option is $2.85 x 100 shares = $285. Again, if you had 1,000 shares, that means you could make $2850. If the share price doesn't end up dropping, you might be forced to sell your shares, so choose a share price that you are comfortable with. If it does drop below the strike price, then you keep your shares and made $2,850 from the sale of the option premium.

Summary

Selling call options is another strategy you can use to increase the amount of money that you earn from your shares. The risk is that the option will be exercised. More often than not, the options are not exercised. Remember that the options contracts have value in and of themselves, and so most of the time, they aren't exercised because options traders are looking to profit off the short-term trading of the options contracts. Also, many options traders are looking for ROI off the smaller investments that options require. While it might cost a trader $221 to buy a call option with a $75 strike price for AppVie, it would cost them $7,500 to buy 100

shares of stock at that price. In many cases, the investor isn't interested in laying out the money to buy the shares and we have an order of magnitude difference between the price of the option and the price of the shares.

While this strategy can be attractive, the risk factor of having to sell the shares will put off many dividend investors. But it might work for you.

Chapter 6:
Top 10 Mistakes Made By
Dividend Investors

Dividend investing tends to attract more level headed people. However, as a beginner, you're likely to make mistakes along the way. By learning what the top mistakes beginning investors are likely to make ahead of time, you can avoid getting into too much trouble, and maybe avoid getting into trouble altogether. In many cases, the problem with the stock market is not so much that people don't have a magic wand that lets them pick the best possible stocks, but instead, it might be people routinely make mistakes that get them into trouble. Avoid making the mistakes and let the general uptrend of the stock market take care of everything else.

Getting anxious to receive a dividend

The way this works out is you see a stock with a good dividend payment, and so, you try and buy it as close as possible to the ex-dividend date to get paid right away. Doing this is creating a situation where you can get yourself into trouble by letting emotion start to take over. Normally, emotion isn't as much of a problem for dividend investors, but once it gets its foot in the door, you can start running into financial problems. The key to avoiding this problem is to take a long-term investing viewpoint and buy shares on a fixed and regular basis.

Only paying attention to yield

It's true that yield can be an important indicator, but you shouldn't be entirely focused on it. Remember that if you are investing in dividends, it's the dividend payment that is the most important metric. Going back to Abbvie (yet again), the forward dividend is $4.28 per share, with a yield of 5.39%. Now, remember the BDC we mentioned a couple of chapters back, Apollo Investment Corp? That BDC had an incredible yield. Checking it today, the yield is 11.52%. But the dividend is only $1.80.

Let me ask you, would you rather make $4.28 per share from AbbVie or only make $1.80 per share? That $4.28 is an extra $2.48 in your pocket, per share. So an investment in AbbVie might be more prudent if making money from the dividend income is your

goal.

Another reason to not get too hyped up by yields is they can be inflated by a declining stock price. One of the first companies we looked at was Consolidated Communications, which has a shockingly high yield of 38%. And guess why? Because their $1.55 dividend payment is for a stock that is only selling for around $4 a share. A high yield on something that has, unfortunately, become a penny stock may not be something that fits your investment goals.

Whether or not yield is important will depend on a wide variety of factors that you are using to evaluate potential investments. But don't just focus on yield alone, look at the entire picture.

Failing to look for growth

On average, dividend investors tend to be more conservative than other types of players in the stock market. Maybe not as conservative as people who will only buy mutual funds, but certainly more conservative than your average growth investor. The goal with dividends is to seek out stable companies that are mature, but you should also get growth-oriented companies that are paying dividends into your portfolio as well. While they may be paying a lower dividend right now, over time, a growth-oriented company may end up paying a higher dividend than an old stalwart like Wells Fargo or Johnson & Johnson. You will want to look at the company's history of paying dividends and see if you spot a trend, and that trend would be increasing dividend payments. Don't look at absolute amounts, look at percentages, and choose companies that raise their dividends by a significant percentage at least once a year.

Not investing in dividend ETFs

Individual stocks are fun to invest in, and people love the excitement of doing the research and being able to track all the different companies. That's great and you can get some great buys in your portfolio. However, you should also invest some of your money into ETFs so that you can take advantage of the massive diversification. This will also act as a hedge to help keep a part of your portfolio stable and secure. I would recommend putting between 25-40% of your dividend investments into 2-3 different

ETFs, probably one that tracks dividend aristocrats, and also include a REIT to diversify your exposure.

Not Diversifying Enough

We've covered a wide range of investments in this book, and you should be investing in all of them. How you allocate your investments are up to you, but strictly buying stocks might be leaving opportunities on the table. For example, there is no reason not to invest in REITs, either individually or through an ETF. You should also invest in at least five MLPs so that you can take advantage of the high distributions and enjoy the tax advantages as well.

Only investing in stocks

Well, okay, we are repeating ourselves … but there are other good investment possibilities out there for income investors. We included one in this book, that was the possibility of selling covered call options. You can use that to generate income now or to magnify the impact of compound interest by reinvesting the money you get from premiums. Another investment that people oriented toward dividends should consider is investing in bonds, which can help generate more monthly income. It's not as lucrative as it once was, due to the lower interest rates we've had over the past 20 years, but it can still add to your income and provide some level of protection for your money. ETFs are a great way to invest in bonds and diversify beyond just investing in dividend stocks.

Buying stocks because they are cheap

Remember that sometimes you get what you pay for. That doesn't mean you have to buy the most expensive stocks on the market in order to build wealth using dividend investing but remember, some stocks might have a low price – because they are not a good investment. As we've noted before, a declining stock might try to use a high dividend payment or yield in order to try and attract investors, who otherwise aren't all that thrilled about investing in the company.

Now, sometimes, a company that is set for better days in the future might have a low share price. Remember, to figure out where the company stands, you need to look at the company's fundamentals.

Look to see how things are changing over time and research the company to see what new products are coming out and so forth. Sometimes, a cheap stock really is a bargain, but you can't go on price alone.

Being Afraid to let go

One of the downsides of dividend investors who by nature are going to be more conservative is that they sometimes can't let go of a stock that isn't worth holding anymore. It can feel like you're betraying your plans when you are investing with the hope of generating a lifelong passive income from dividend payments, and the stock starts performing so badly, it's clear to the mind but not the heart, that you need to get out. Use the same muscles in your brain that you would use to evaluate a cheap stock you were thinking of buying and analyze the company. Read what the experts are saying about the company. A good rule of thumb is to use three stock services to see what they are saying, so you could use Zacks and Morningstar plus one other as we discussed in parts of this book. If 2 out of 3 agree that something is a sell or a strong sell, then sell your shares and move on. You can use the proceeds from the sale to invest in a new stock or put it into an existing stock already in your portfolio that is already performing better.

Not taking your taxes into account

Remember, investing in the stock market isn't free, and any cash you take out is going to be taxed. You may not like it but that's the way things go. So, it's important to be familiar with the tax laws that apply to dividend stocks so you have an idea of what you're going to have to pay from the various profits you are making in this enterprise. You don't have to have the expertise of an accountant, but don't take money out and say you're going to worry about the taxes later. Have some idea of what the taxes might be and be sure to pay estimated taxes so that you don't find yourself falling behind later and then having a massive tax bill. Another concern and this is the one I was really getting to when it comes to failing to take into account taxes, is that you overestimate your profits. When you figure taxes into your transactions, you might find out that your gains are not as great as you thought they were. If you are going to be building an income from dividends, it's a good idea to have an accountant rather than trying to fly alone using tax software.

Not Doing Due Diligence

The final mistake that we'll look at in our list is taking a cavalier attitude toward your investments. Many people don't put the time into studying the market and the companies they are investing in or want to invest in, and as a result, they don't invest nearly as well as they could. Rather than keeping abreast of what's going on, they just invest in what they feel like investing in. That could make the difference between making $26,000 a year or $75,000 a year from your investments. When you are going to buy a stock, you should be able to clearly explain to someone else the exact reasons that you would buy the stock and what you're expecting to get out of it, as far as both the dividend payments and capital appreciation of the shares.

Chapter 7:
Tax Implications

This part of the book is the least enjoyable. But let's face it; most of us don't know much of anything about how our complex tax code is going to be applied when it comes to the stock market and to dividends. If you're a beginning investor, that is definitely true. The first advice that should be given is that if you build up a large portfolio of stocks, you're going to need to use a professional accountant. But having some understanding of the general rules will help as well. Remember in the last chapter, one thing we mentioned is you don't want to get into a situation where taxes end up cutting into your profits.

Ordinary versus Qualified Dividends

The first thing to be aware of is the difference between ordinary and qualified dividends. The kinds of dividends that we've been talking about in this book are ordinary dividends. That means that the income from them is, well, ordinary. In other words, the proceeds are taxed as ordinary income.

A qualified dividend comes from a capital gain. Following the kind of investments that we have described in this book, you're probably not going to be getting qualified dividends.

Example: Suppose you're in the top tax bracket. You get $100,000 in qualified dividends. That is taxed at the capital gains rate, so you'd owe $20,000 in tax.

Example: You get $100,000 in ordinary dividend payments from your investment in IBM. Since they are more than $1,500, you have to fill out a schedule B and then report them with your 1040.

Tax Forms

The dividends that you get from an investment in dividend stock will be reported on a form 1099-DIV. If you are getting dividend payments from an s-corporation or trust, they will be reported on a form K-1. Note that investments in vehicles like an MLP will generate a K-1.

Dividends that you reinvest

Unfortunately, the geniuses in Congress didn't see that it was fit to prevent this in the interest of promoting investment, but dividends that you reinvest are still subject to tax, so you have to report any dividends that you receive on your tax return and pay taxes for ordinary income on them.

Example: You earned $25,000 in dividends, but you reinvested them buying more shares. You still have to pay the tax on them. Like the example above, they are more than $1,500, and so, you need to report them on schedule B of your 1040.

Some tricks to lower your tax burden

If you have an individual retirement account, your money in the account is allowed to grow tax-free. One downside is that the wise old men of Congress limit how much you can invest in an individual retirement account to around $5,500 -6,500 per year depending on age. However, there is a nice trick you can use with dividends inside the individual retirement account. You can use the account to buy dividend earning stocks. Then, when the dividends are paid, they are paid inside your IRA. That means that they are tax-free, and you can reinvest them inside the IRA. Keep in mind that when the money is taken out of your IRA after you retire, if you have a traditional IRA, you're going to have to pay taxes on it at that time (a Roth IRA means you pay taxes on the money now, but the money is tax-free later when you withdraw it).

So, the procedure to avoid paying taxes on dividends is:

- Open an IRA or use an employer retirement account like a 401k
- Buy dividend stocks inside the retirement account
- Reinvest the dividends inside the retirement account
- That way you won't face taxes on the dividends

The same trick can be used to massively grow your retirement accounts using covered calls. So, you buy shares inside the IRA, and then sell covered calls with the IRA account. Odds are good that most of the time the options aren't going to be exercised. So, you make, say, $2,500 profit a month selling covered calls, and it's inside your IRA, and it's going to be tax-free since the account is allowed to grow tax-free. Then you use the funds from your covered

calls to keep buying more shares. So, although you're only limited to putting in a relatively small amount each year after you've built up a few hundred shares, you can start earning money from selling covered calls and reinvesting the dividends. Then, when you start pulling money out of the IRA when you've retired, you will pay taxes on the money at that time.

Chapter 8:
Starting Late

In this chapter, I would like to briefly address a problem that far too many Americans have today, despite the opportunities all around us for investing. The fact of the matter is many people have failed to save and invest and now find themselves 50 and older without any net worth. Millions of Americans can't even come up with the cash to pay a $500 emergency. This situation means that tens of millions may be heading toward retirement without any investments to speak of or only a small 401k that was provided by their employer. They are hoping to get by in retirement on social security, and maybe, they are even thinking about continuing to work well into their 70s.

That paints a grim picture, especially when you consider that simply following a few rules can help you build amazing levels of wealth over time. The reality is that it's definitely better if you start investing when you're young, and I hope that at least some readers are still in their 20s and 30s and are looking for ways to build up some wealth so they can at least be secure in their retirement, and who knows, many will be able to retire early and live off the income that dividend investments can provide.

However, all is not lost. Even if you are 50, 60, or even older, it's never too late to do something. In this chapter, I would like to discuss a few ways for you to accelerate your investments so that you don't have to get by eating cat food in your retirement years.

If you don't have a retirement account open an IRA

You can open a traditional IRA all the way until age 70 ½. You can only invest $6,500 a year if you are over age 50, but remember that every little bit counts and you can build up a little nest egg over time that can add to your income from social security. You should open one as soon as possible if you are age 50 or over and you don't have any savings or investments. The maximum you can invest is $6,500 a year, and that is only $542 a month. For some people, that will be a big expense, but how big is it going to be when you are 75 years old and have no income at all besides a small social security payment? If you have to take on a second job or do something like drive for Uber or deliver for Door Dash, you need to start doing it

now and get that extra $542 and invest it every single month. If you start buying dividend stocks now, then 20 years from now, you will be able to earn some income from them and avoid complete poverty. Also, remember the trick I provided about taxes and using an IRA account, you can grow your account faster than imagined by just investing $6,500 a year by selling covered calls and reinvesting your dividends.

Find ways to earn more income and invest it

I hate to sound too repetitive, but the modern economy provides many ways to earn extra money. You should take up as many gigs as you can. If you have no savings and investment, you need to do it and get going on this now. Take the money you earn from a second job or from gigs and use it not only to fund an IRA but to start building the kind of dividend plan that we've described in this book.

Buy and Sell Options

Buying and selling options is a good way to start profiting from the stock market because you can start small. However, a word of caution – profiting from options is a little bit tricky. Don't just go out and start doing it. You need to read books and take a course or two to really learn how to do it properly. What I am talking about here is different than what we discussed about options earlier in the book. I am suggesting that you put some time in to become an options trader, not using your stocks to sell covered calls (but you can do that too, and you should be doing it if you are low on your investments and need to raise more cash, but own some shares). Trading options can begin one contract at a time, investing in amounts of $50, $100, or more. Think long term and do it carefully. You are going to have some losses, but if you follow the advice outlined here, and take some courses, your odds of having far more wins will be significantly increased. The only other thing to say here is don't go all in on options, do small amounts each month, say a few hundred dollars. If you can get to where you invest $500 and come out with $1,000 in many months, then you can take your profits and invest them in dividend stocks. Options are a low-cost way to start accelerating the investment plans that you should have started years ago.

Have a regular dividend stock plan

Develop a plan to start buying solid dividend stocks at a level that you can afford. Make it a plan that you're not going to avoid carrying out because you're faced with buying a few shares or paying the electric bill. Once you settle on a plan, carry it out and don't deviate. The only change should be increasing your stock purchases when you can afford it.

Don't cheat yourself with early withdrawals

If you are not financially secure, the temptation will be there to pull money out of your investments and spend it now. That is a huge mistake; you're actually throwing away large sums of money that you would earn if you left the money invested. If you find yourself needing extra money, find another way to get it.

Conclusion

Thanks for finishing this book and taking the time to read it. I am hopeful that you enjoyed the book and found it informative.

Investing in the stock market can be very exciting and lucrative. If done correctly, you can use your investments in the stock market over time to grow your wealth and after a number of years; you can earn a significant living from dividends alone. Take your time and evaluate each investment before putting your money in, so that you don't end up wasting it.

If you enjoyed this book, please take a few minutes to leave a review for us on Amazon!

DAY TRADING

Learn the best strategies to start making money with stocks, futures, forex, options, penny stocks, ETFs and cryptocurrencies

Introduction

Congratulations on downloading this book, and thank you for doing so.

The following chapters will discuss everything that you need to know about day trading. Day trading is becoming popular around the world because it provides a way of earning lots of money from the comfort of your home office.

This book will introduce you today, trading in simple and clear language that is easy to understand. You will learn all about day trading, about how to trade, how to find profitable securities, and how to take profits. You will also learn where to search for stocks, what tools and systems to use, and how to prevent against all kinds of risks. If you learn how to trade and apply correctly the lessons learned here, you will soon be on your way to financial freedom.

There are plenty of books on this subject on the market, thanks again for choosing this one! Every effort was made to ensure it is full of as much useful information as possible. Please enjoy!

Chapter 1:
The Basics of Day Trading

An Introduction to Day Trading

For many decades, the only ones who were able to engage in trade at the financial or securities markets were employees of brokerages, investment banks, trading houses, and other financial institutions. The rest of us and all others with investment dreams had to rely on these institutions to invest on our behalf. However, the advent of the digital age, easy access to connectivity, and the internet, as well as an understanding of the markets, makes it easy for any interested person to become a trader.

Today, there are hundreds of thousands of retail traders spread throughout the world. They are able to trade the markets and engage in regular sale and purchase of different securities. This has all been made possible through digital platforms and internet connectivity. One of the more popular trading styles is day trading. Day trading can become an extremely lucrative and rewarding career for traders who trade the right way.

What is Day Trading?

It is important to emphasize from the onset that day trading is not investing. Investing is the purchase of securities such as shares, bonds, or currencies and holding them in the hope that the price will rise so they can be sold for a profit. Day trading has a totally different approach.



Investors are, in most cases, focused on the performance of the investments or companies where they invest their money. Some hold their money in these securities for a long time, maybe even years. Investors often search for solid companies that have a proven profitable track record and a solid business plan.

Day trading is very different from investing. It is the process of selling and purchasing securities, especially stocks, within the course of a trading day. A day trader will purchase security during the course of a trading day and then sell it before the close of the trading day.

In some cases, day traders borrow money and use the borrowed funds to benefit from price movements at the market. They use borrowed funds to purchase stocks at low prices and hope to then sell these at higher rates and make a profit albeit small. In fact, day traders are constantly buying and selling stocks or securities. They rely on these small and minute profits that they make throughout the trading day. At these end of the day, these can add up to a decent amount.

Day trading happens in different markets, but it is more common in the Forex or currency markets as well as the stock market. Day traders are generally well-funded and highly educated finance professionals. They spend most of their days studying the markets and trading for profit. A lot of their work involves the application of short-term trade strategies and plenty of leverage. This enables

them to take advantage of minute price changes in securities that are highly liquid.

It is safe to conclude that day traders engage in the sale and purchase of financial instruments hoping to benefit from price movements of the stock or other security within the course of the trading day. Traders enter positions and hold them for only a couple of seconds or minutes before exiting. Exits generally suggest a small profit has been made, but sometimes it implies a loss. The only difference is that by trading day's end, the successful trades should be significantly more than the failed ones for a profit to be realized.

While positions are mostly held for a couple of seconds or minutes, they can also be held for hours and even tens of hours. The crucial aspect is that all trades or positions have to be closed by the end of the trading day. Day traders want to avoid the risks of overnight incidences, risks, or exposures. This is the reason why this specific trading strategy requires positions to be closed before then.

Entering a position or buying security, then exiting the position by selling the security is sometimes referred to as a round trip. For instance, if a trader enters a position by buying 200 shares of ABC stock at $32 and then exits by selling them after 35 minutes at a price of $35, we can say that the trader made a successful round trip.

In essence, day trading can be termed as the process of make a number of round trips on a speculative basis conducted within trading times. We can compare or contrast it to swing trading where traders get to hold positions for much longer periods. These range from overnight to a couple of days.

Day Trader Characteristics

Day traders carry certain characteristics that are common and cut across players in this strategy. First of all, they are professional traders who trade for a living and not a hobby. As professional traders, they possess serious knowledge of the markets and have mastered a couple of trading strategies and setups. In essence, there are certain characteristics that are common to most day traders. Here is a closer look at these characteristics.

Experience and Marketplace Knowledge

Day traders have a deep understanding of how the markets work. They have mastered the functions and operations of the markets and know the tips and tricks necessary for successful trading. There are others who enter the markets with insufficient knowledge about how the markets work. Unfortunately, such individuals stand no chance of success and often lose money. It is imperative that any potential trader takes time to learn the trade before going live

Sufficient Trading Capital

Traders need to have sufficient funds if they are to trade and be profitable. Day trading relies on very small or minute market movements. Small capital amounts will not realize sufficient profits. However, with sufficient funding, it is possible to be profitable as traders can enter more positions.

Also, traders use what is known as risk capital. Risk capital is capital, which a trader can afford to lose without going under. This is crucial as it protects them from any imminent losses. Using risk capital also helps to get rid of emotional trading. A lot of traders sometimes let emotions get the better of them. Emotions cause traders to abandon their trading plans and panic. This cannot be a good strategy and should be avoided at all costs.

A Suitable Trading Strategy

A successful day trader is one with a suitable trading strategy. Such a strategy gives him an edge over the market. Coming up with a strategy is not necessarily an easy feat. It takes time, planning, and analysis. There are a couple of strategies that they use, such as arbitrage. They spend significant amounts of time perfecting these strategies so they may implement them without hesitation and with enough confidence. Traders often spend hours perfecting strategies so that they eventually limit losses and capitalize on profitability.

Discipline

Another essential ingredient that constitutes a crucial characteristic of day traders is discipline. Without discipline, no trader will be successful. Discipline, in this case, refers to coming up with a strategy and sticking by it without letting emotions come into play.

All too often inexperienced or novice traders lose money because they do not stick to their trading plans or strategies. They tend to deviate based on hunches, feelings, or even panic. Emotional trading is an enemy of any trader. Experts always advise traders to plan their trades then trade their plans. Successful traders are disciplined traders, while undisciplined traders have no chance of success.

It is better to implement a strategy unsuccessfully than abandon one altogether for fear of losing money. The reason is that a well-planned strategy provides for a certain percentage of loss, such as 5%. Traders place stop loss points at 5% and sometimes 9% so that any losses exceeding these amounts terminates the trade, and the trader exits the position.

Emotional traders disregard all their plans and trade according to their feelings. For instance, when they incur a slight loss, they panic and exit a trade. At other times they allow losses to continue for too long so that their trading capital is drastically reduced. The bottom line is that traders should stick to their trading plans.

How Day Trading Works

Understanding how day trading works is pretty easy and straightforward. First and foremost, we have day traders, active traders, and even hyperactive day traders. Terms depend on the number of trades entered per day and even per year.

To be profitable, a day trader counts on volatility. Volatility refers to the abrupt rise and fall in the price of securities such as shares and currencies. Day traders love stocks that experience a lot of volatility and move a lot in the course of the trading day. However, stocks do not just move for no reason. There are certain causes of market volatility. Some of these include company news, the state of the general economy, investor sentiments, earnings reports, and so on.

Apart from volatility, day traders also prefer stocks that are highly liquid. This means that a trader is easily able to enter and exit trades when the stocks are liquid. They also exit without altering the stock price by any significant margin.

Individual and Corporate Day Traders

There are generally two types of day traders. We have day traders who are independent and earn their living through day trading. We also have day traders who work for corporations. These constitute the majority of day traders. They enjoy certain benefits of working together in large groups compared to individual retail traders.

One of the benefits that corporate day traders enjoy is access to large amounts of capital. They also enjoy plenty of leverage that enables them to enter numerous traders and exit profitably. They also have a direct line as well as a trading desk. These are facilities that other traders would die to have. They also enjoy access to superior analytical software and unlimited funds.

For these reasons, they are able to take on more trades and trade with lots of leverage. They are also able to enter positions that other traders cannot. Corporate day traders find arbitrage opportunities in order to make easy profits throughout the trading day. They mostly focus on easy trades that are less risky way before other traders move in. With the resources that they have as well as the opportunities presented by the markets, day traders are able to trade successfully and generate lots of profits.

Some day traders either trade using their own money or use other people's money to trade. However, most day traders previously worked for corporations and as such have access to certain beneficial facilities like a trading desk. A lot of them have relationships with brokerage firms as they spend lots of funds paying commissions. However, individual retail traders are not in a position to compete fairly with institutional traders. They lack the facilities and financial resources needed to engage in large-scale, profitable trades like their corporate counterparts. This is the reason why such traders often take on riskier trades just so they can make sufficient profits

Requirements for Successful Day Trading

There is a lot to learn for anyone seeking to become a professional day trader. There are also a number of requirements that are essential for successful trading. Here is a closer look at some of the requirements.

1. A Trading Desk

One of the essential requirements of a good day trader is access to a

trading desk. In most cases, such a desk would be reserved for corporate traders and day traders with access to large capital amounts. A suitable trading desk provides traders with the ability to place instant orders and execute them instantly.

A trading desk is a wealth of information. For instance, if there is an impending takeover, then the trading desk will provide necessary information that a day trader can use to quickly enter trades and benefit from the intended takeover and so on. The trader can easily and speedily enter and exit positions via the trading desk.

2. Access to Multiple Sources of News

It is crucial for day traders to have access to the latest news. Any breaking news, especially from the business, financial, or political fronts, will have a major impact on the price as well as the movement of stocks and other securities at the financial markets. Traders who receive the news fast will have an opportunity to incorporate the implications into their analysis so they can either take advantage of or action against it.

News, whether good or bad, is considered positive because it can impact stocks and cause volatility. Day traders thrive on volatility, which means more volatility results in increased stock market activity. A typical trading desk comes equipped with ready access to certain news sources including regular news coverage on CNBC, Dow Jones news source, and lots of others.

There are a good number of reliable news sources as well as online platforms that can be accessed, such as Yahoo Finance and Google Finance. These sources often have respected analysts who analyze the news in a manner that is beneficial to traders, including day traders. A good trader is able to take in the news analysis and determine how this news will affect stocks at the market. The trader is then able to capitalize on this and make a profit.

3. Access to Latest Analytical Software

Among other things that traders need access to is appropriate trading software. Analytical software is essential for trading the markets, for entering and exiting positions, and for long-term profitability. The software is of different kinds. Basically, traders who rely more on swing trades and technical indicators. They can

be categorized in the following manner.

Back-testing Software: This is a type of analytical software that enables traders to test a strategy to observe its possible performance when implemented at the markets. The system or software is able to perform the analysis in an accurate and reliable manner so that traders can rely on it. The only point to note in this case is that past performance sometimes is not a great indicator of future outcomes.

Broker Integration: Trader platforms integrate seamlessly with the trading software such that trades are executed either automatically or instantaneously. This kind of integration with a brokerage is extremely useful and very convenient as it speeds up the trading process, improves trade execution times, and eliminates emotions from the entire process.

Neutral and Genetic Applications: The software comes with certain application programs that utilize genetic algorithms and neural networks. These networks and algorithms help in perfecting the trading systems so that their predictions are more accurate in terms of future price movements.

Automated Pattern Recognition: We also have what is known as the automated recognition of trading patterns. This is especially useful for traders who rely on technical indicators such as channels, flags, or even wave patterns. The software easily recognizes these patterns and makes it easy for traders to implement their strategies without a hitch.

Important Points to Ponder

There is an ongoing debate on Wall Street and other major trading hubs about the potential profitability of day trading. One of the reasons for this is the rapid increase in instances of fake trading sites and trading scams. These have, over the years, lured innocent individuals, mostly green and novice investors, who then trade on these fraudulent platforms.

A lot of these scammers market day trading as a get-rich-quick program where traders can become overnight millionaires and so on. Some of these platforms lure traders with very little knowledge or experience about trading. This causes numerous investors and traders to take a negative view of this otherwise noble and fulfilling

profession. Facts still show there are numerous successful day traders who engage with professionals all over the world. They enjoy success regardless of online scams and fraudulent activities.

Even financial advisors and professional managers tend to opt for other strategies as they probably do not understand or comprehend this specific strategy. However, it is possible to be a day trader and make significant profits on a regular basis. Many traders are trading profitably and leading successful lives based on their trading proceeds. It is accurate to state that day trading is not for everybody, and it is inherently a risky venture. However, those who do take the time to learn the trade, understand it, and take to perfect the art are likely to be successful in the long run.

Day trading is a viable way of earning a significant income despite the stories and scams that are out there. Both retail and institutional traders trade almost every day and thrive at it. Many are successful and play crucial roles in the market. They introduce liquidity and ensure the markets remain efficient. In essence, day trading should be left to experts and professionals who have the resources and skills needed for successful trading.

Day Trading Vs. Swing Trading

There are different kinds of traders out there. We have active traders who are either swing traders or day traders. Both of these strategies tend to profit over relatively small time periods. In both instances, traders will enter a position in the market and then exit after a relatively short period of time. This contrasts investors who tend to invest their money in the markets for long periods of time. There are major differences between day trading and swing trading. Here is a closer look at some of these differences.

☐ Level of Effort Needed

Day Trading

Day trading is an extremely involving strategy. Traders need to basically cancel all other engagements so they can focus on trading. This is because positions are often entered and exited in a matter of minutes and sometimes seconds. Losing focus for just a couple of minutes can cause a trader to lose money. Sometimes day traders are unable to take a bathroom or coffee break because day trading

is that engaging. To newbies and beginners, it can be a daunting and sometimes even an arduous and insurmountable experience.

Day traders have to analyze the markets each and every single day. The analysis often happens early in the morning after waking up and just before the trading day begins. Day traders also need to choose a trading time-frame such as morning or afternoon sessions because the tasks are so demanding. It is almost impossible to switch between day trading and the TV.

Traders suffer from headaches and stress because of the constant vigil demanded. There are actually day traders who trade the entire day and are profitable. The challenge is that day trading is so demanding it takes traders away from regular activities like preparing lunch and so on.

Swing Trading

Swing trading, on the other hand, is hardly as demanding as day trading. It does not demand constant vigil and is easily spread out across a trading day and sometimes even beyond. Watching stocks is essential for every trader to ensure that important levels are maintained. A hawkish watch is not necessary in this case.

A lot of traders choose part-time trading and still make a decent profit each week or month. This shows that it is possible to profit at the markets without the need to be constantly fixated to the screen. Swing traders generally don't have many trade-related decisions to make compared to their day trading counterparts.

- Profit Expectations Per Trade

Day traders often make much smaller profits with their trade. They generally enter a position and quit within a matter of a few minutes and sometimes an hour or two. They never last long in any entered position. The average trade times range between a minute to 3 minutes, 5 minutes, or 15 minutes. Rarely do trades last longer than these times.

Due to the use of smaller time frames, the resulting profits are equally small. Profits are generally proportionate to the trading times. The general belief is that traders should earn a few pennies per trade if they are to be profitable in the long run. It is interesting

to note that there are high-frequency trading systems with the capacity to support hundreds and even thousands of trades and make significantly more money compared to retail traders.

Day traders need to have a target at the beginning of each trading day. This means targeting to make perhaps $100, $200, or $300 per day. This way, traders will be able to monitor their progress and hence gauge their performance. Stocks barely trend in the same direction for 3 straight hours. Chances of this happening are only about 20%. A good trader will then capitalize on the 80% time that stock prices head downwards.

Swing trading is an art that can be mastered. It, however, requires dedication, plenty of hard work, and time on the trading platforms. In fact, traders can make much larger profits from swing trading compared to day trading. This is because they have much larger trading times with less pressure than day traders.

- Trades Entered Per Day

Day traders are always entering and exiting trades. In fact, day trading is all about entering and exiting market positions in the course of a trading day. Day traders can enter a single position or even a hundred different positions in a single day. Manual trading is not advised at this juncture because it increases the chances of losing money. Automating the day trading process is highly advisable. Manual day traders should ideally only trade between 3 and 5 times each trading day.

When it comes to swing trading, traders do not have to enter positions each and every single trading day. Swing traders sometimes enter only 2 or 3 positions in the course of a trading week. The reason why swing trades take a little longer is that the stocks need time to swing from one position to the next. There is always a plan being executed after technical analysis. This plan requires time in order to unfold as desired. However, the markets are quite unpredictable, and anything can happen. A stock that was not expected to move significantly for days may move significantly after only a couple of hours.

- Money Management Tips

Good money management skills are essential for all day traders.

Day traders are able to trade using 3 to 4 times of the funds in their account. For instance, a day trader with $10,000 has access up to $40,000 to use as trading capital. However, this can be a risky affair because the funds are a form of credit. Trading is a risky affair, and losing trading capital is bad enough.

However, losing borrowed funds can be disastrous, so only experienced day traders should only use trading capital that is accessible to them and do so prudently. Day traders have to make fast, prudent, decisions on the trading platform. This means they need to know the amount of capital available to them.

Important Day Trading Terminology

1. Basic Trading Terminology

As a day trader, there are certain terms you need to be familiar with. You can expect to come across these terms in the course of your trading career and most of them on a daily or regular basis. Here are some of the more common terminologies.

A Professional Day Trader

This is a securities trader who engages in day trading for a living. Many day traders who trade for a living are licensed professionals. Most brokers charge professional traders higher fees. This is the reason why brokers need to know whether traders are licensed or not. However, a trader trading using personal funds needs not to be licensed.

Pattern Day Trade Regulations or Rules

Pattern Day Trader or PDT rules define a day trader by specifying the number of trades taken per day. Any securities trader who enters 3 positions or more within a 5-day period is generally considered to be a day trader. Such traders are required by the PDT rules to generally have at least $25,000 in their trading account.

Swing Trader

A swing trader is a securities trader who contrasts the day trader is certain ways. Swing traders enter positions just like day traders, but they do not exit positions in a hurry. A swing trader generally holds positions at least overnight. This is the distinct difference between

day trading and swing trading. Sometimes this time period can extend to a couple of days, but the minimum is always overnight. Both instances are short-term investment strategies.

Initial Public Offering

Companies sometimes issue what is known as an IPO. An IPO or initial public offering occurs when a company makes its shares available to the public for the very first time. Selling an IPO enables companies to raise funds that they need for various spending programs. Companies sometimes require funds to venture into new markets, to develop a new product line, and lots of other large capital programs or projects that they may have. Companies are able to raise hundreds of millions of dollars and in some instances, even tens of billions of dollars. Numerous companies have successfully issued IPOs and grown to become even larger and more successful.

Bullish or Bull

When the market is doing well, and all indicators are strong, and the trend is heading upwards, such a situation is referred to as bullish. A bull market is one that is generally strong and performing well. Traders love bullish markets because they have better chances of trading profitably. Stock prices rise in a bullish market.

Bear or Bearish

There are situations when the markets are not performing well. Stocks may be losing money and prices headed down. A market where shareholders and investors are losing money is said to be a bear market and the stocks bearish. Traders sometimes assume a market will take a bearish position. In such cases, they tend to assume bearish positions, get rid of bullish positions and sometimes even enter short trades.

Trading Hours

The stock market has certain specific open hours. It opens at 9.30 am on Monday morning and closes at 4.00 pm evening. The last trading day of the week is 4.00 pm. Therefore, the markets are open Monday to Friday from 9.30 am to 4.00 pm. Of course, there is after-hours trading that is available to traders. The problem is that

at such times, liquidity is very low, and there is hardly any momentum or volatility. The reason is that there are often a few buyers and little activity after hours.

Float

When it comes to trade, the term float refers to outstanding shares. For instance, after an IPO has been issued, the shares released are considered outstanding. The supply of shares is always equal to the float. When there is a limited float, then these are expected to move extremely fast at the markets.

Share Buy Back

We have what is known as a share buyback. This term refers to when a listed company chooses to exercise its right to purchase back all its shares that were previously sold during an IPO. When companies do this, they essentially reduce the number of shares that can be traded, and therefore, holders will see the value of their shares increase. The net effect of a share buyback is a decrease in the float.

2. Additional Day Trading Terminology

ADR

The term ADR refers to easier access to foreign-owned public firms by US investors. ADRs benefit foreign firms because interested investors are able to buy into them rather than simply firms within their borders.

Alternative Investment Market

AIM or alternative investment market is a term that refers to security's markets section where relatively new companies can go to seek funding. The first one was established in the UK back in 1995.

Amortization

The term amortization has two different meanings. It can imply payment or servicing of credit in regular and incremental amounts. Amortization can also imply the process of value reduction of assets in order to report their true value accurately in time.

Arbitrage

This term refers to a particular technique used by traders to benefit from the price difference in assets that are substantially similar across various markets and sometimes in different financial instruments.

Balance of Payments

A country's accounts that basically summarize its financial matters compared to that of other countries.

Beta

The beta coefficient or simply beta is simply a method of calculating the relative risk that is inherent in a particular stock or share.

Bid-Offer Spread

The bid-ask spread or bid-offer spread is the difference between the selling price and buying price of a share or any other security.

Diversification

Investors need to diversify their portfolios. Diversification is a crucial aspect of investment strategy. It is adapted in order to help manage risks posed investing in only one or perhaps two securities. Spreading out the investment into other securities helps to spread and hence minimize risk.

Derivatives

The term derivative refers to a class of securities and financial instruments that derive their price or value on an underlying asset. A good example of this is options trading where options derive their values from an underlying asset such as stocks.

ETF

An ETF is an exchange-traded fund. This fund consists of a variety of securities that keep track of an underlying index. The index in question is made up of the securities within the fund. As such, an ETF also acts as security unto itself.

Fibonacci

This term originates from a famous 13th Century Italian mathematician known as Leonardo Fibonacci. The Fibonacci theory has a number of sequences where every number is arrived at by

adding the two preceding numerals. This sequence enables traders to find technical indicators they need for their trades.

Indices

Securities markets have indices which constitute a hypothetical number of securities. These provide a clear picture or image of a specific market sector. Indices have a value, and this value is considered a fair representation of the inherent value of the constituent securities.

Risk Reversal

This refers to a risk management strategy useful when hedging certain directional strategies. For instance, a trade can hedge a long position two-fold via the risk reversal approach.

Sharpe Ratio

This ratio is used to determine the returns obtained for every single risk unit. It is important to measure risks so that only worthwhile risks are taken while those deemed too risky without worthy returns are abandoned.

P.E. or Price Earnings Ratio

The price-earnings ratio is a ratio used to determine a company's relative value

PPP or Purchasing Power Parity

Purchasing power parity is basically a useful theory used by traders to determine how much one currency, or security, is undervalued compared to another.

Recession

A recession usually refers to a drop in GDP or gross domestic product of a nation for at least two consecutive quarters. The figure is usually adjusted to accommodate inflation.

Resistance Points

Shares are in some cases traded in what are known as channels. The price oscillates within the channel but never breaks out. The paths within these price confines are referred to as resistance points.

Rights Issue

This is a share issue by a company to its existing shareholders. Shareholders are given a chance to purchase new shares often in proportion to their current holdings.

S&P 500 Index

The S&P500 is an American index that is among the top indexes in the Western world.

Shorting

This is a strategy used by certain traders when they want to profit from an asset, or financial instrument whose price they believe is about to fall.

Spread

Spread refers to the difference or gap between two points. In trade, the term spread refers to the difference between the buy price and the selling price. It is via the spread that traders make their profits.

Stamp Duty

Traders have to pay taxes, and one of these is stamp duty. This is the tax paid by traders when they purchase registered security. However, the same is not paid when the asset or security is then sold.

Standard Deviation

This is one of the most popular measures of dispersion used, not just in statistics but in the trade as well. It is mostly used to measure risk in financial markets as well as dispersion.

Stop Loss

Brokers regularly receive instructions from traders about their trading plans. One such instruction is the stop loss. This instruction requires the broker to sell a stock once a certain price is breached or when the price falls beyond a certain point.

Technical Analysis

A technical analyst is an expert, also known as a “chartist.” The

main purpose of a technical analyst is to predict future price movement based on past performance. Any stock with a documented history

Treasury Bonds

A treasury bond is a bond that is issued by a government for purposes of obtaining funds to carry out its functions. Government bonds are a form of IOU and are considered among the safest forms of credit available.

Underwriting

Whenever a public company issues new shares to the public, there is a certain guarantee necessary about the minimum amount of proceeds they can expect from the sale. Firms often come forward to guarantee this by way of underwriting this minimum.

Volatility

One of the most crucial terms of trading is volatility. This term refers to the unpredictable fluctuations of an asset's price that occur at the market. The asset, in this case, can be stocks, bonds, currencies, and so on.

Volume

Volume refers to the number of stocks or securities. For instance, a trader can buy 100,000 shares of a particular stock. This figure generally refers to the volume of the stock purchased.

Chapter 2:
Common Securities Traded

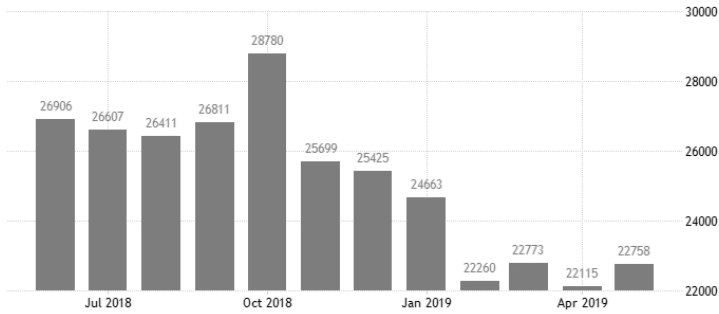
On any typical trading day, a day trader will enter both long and short positions within the course of the day. All these trades are largely conducted online, and there are brokers whose platforms facilitate trades. A trader can be profitable or not depending on certain factors but mostly intraday movements of stock prices and all other financial instruments prices. Day traders hardly hold positions overnight. They exit all positions before close of the day.

Day trading has for a long time been a viable option for committed traders who take the time to learn the trade and commit themselves to work hard to earn either a fulltime income or extra cash on the side. There are those who view day trading as a risky method of earning a living because of the unpredictable nature of the markets. However, well-informed traders are able to trade successfully through education, practice, caution, use of established trading systems, and setups. They can be profitable in the short, medium, and long terms. On the other hand, amateur and poorly trained traders are likely to lose money.

Day Traders

As has already been established, day traders engage in the purchase and sale of stocks or other securities in the hope of profiting from the frequently changing prices. There is a similarity between day trading and investing or even other trading strategies. The main difference is the time that assets are held. Investors hold onto investments the longest while day traders do so for a maximum of one single day.

There are hundreds of thousands of traders across the world, including almost five hundred thousand in India alone, who are day traders and earn their livelihoods trading. However, regardless of the success that these traders enjoy, trading is not an easy feat. It needs serious focus, mastering of trading techniques, strategies, vigilance, and discipline.



It requires a proper understanding of how trading works. Those who are able to master the markets will be successful while those who choose not may struggle and possibly lose money. This is never the desire of any trader. As such, only those who are well trained, with sufficient experience, and the discipline needed should practice day trading.

It is safe to conclude that day traders engage in the sale and purchase of financial instruments hoping to benefit from price movements of the stock or other security within the course of the trading day. Traders enter positions and hold them for only a couple of seconds or minutes before exiting. Exits generally suggest a small profit has been made, but sometimes it implies a loss. The only difference is that by trading day's end, the successful trades should be significantly more than the failed ones for a profit to be realized.

While positions are mostly held for a couple of seconds or minutes, they can also be held for hours and even tens of hours. The crucial aspect is that all trades or positions have to be closed by the end of the trading day. Day traders want to avoid the risks of overnight incidences, risks, or exposures. This is the reason why this specific trading strategy requires positions to be closed before then.

Just like all other traders and investors, day traders are in it to make money, earn a living, and possibly even become wealthy. After all, this is possible with the right strategy, patience, and discipline. The only difference between day traders and all others is that they seek to benefit from cashing in on small, minute, price movements.

Also, day traders use what is known as risk capital. Risk capital is

capital, which a trader can afford to lose without going under. This is crucial as it protects them from any imminent losses. Using risk capital also helps to get rid of emotional trading. A lot of traders sometimes let emotions get the better of them. Emotions cause traders to abandon their trading plans and panic. This cannot be a good strategy and should be avoided at all costs.

It takes time before a day trader eventually becomes successful. It takes patience as well as wide understanding and knowledge of the market. There are those who believe day trading is easy, or it is not that involving. Such thoughts are totally misguided because day trading is easy, and it does require a lot of commitment. Traders need to be extremely patient and vigilant. Other requirements of a prudent trader are in-depth market knowledge and a good mental state. Traders need to follow their trading plan without letting emotions get in the way.

All these are the desired characteristics and qualities necessary for successful day trading. Any profits made on the trading floor are often subject to commission deductions because the broker has to be paid a certain commission. A trader with all these qualities and characteristics needs to then understand the consequences and benefits of being a fulltime trader. It is crucial that a trader gets to find out whether trading is for them and if it suits their way of life. In essence, a trader needs to learn about the advantages and disadvantages of being a day trader. Here is a look at some of the pros and cons.

Pros and Cons of Day Trading

- PROS

It is Hugely Profitable

One of the best aspects of day trading according to most people is that it is possible to make lots cash within a relatively short period of time. Anyone who learns the trade and is willing to put in the time and take risks involved is likely to make plenty of cash.

To be successful at making money, a trader needs to develop a well-thought-out strategy and have a proper understanding of how the markets work. Traders have learned to increase their earnings through leverage. Leverage is simply money that is usually

borrowed from the broker. This money is borrowed solely for trading purposes so that traders can make even more money.

Those working for large corporations often have access to costly software and other benefits that make their trading easier and faster. These include a direct connection to the dealing point as well as access to large amounts of trading capital and so on.

Serve Crucial Role at the Markets

Day trades play an absolutely crucial role in the markets. This is mostly because of arbitrage. Arbitrage is a general day trading strategy that also helps to identify any discrepancies within the market. Basically, if there is a discrepancy when it comes to asset prices, then this will easily be noted using this specific strategy.

In an ideal situation, the value of securities should be equal across the board. When this is not the case, then day traders will uncover it and help alert the market so that it can be remedied. Traders are also able to take advantage of the situation by selling the expensive ones and then purchasing the cheaper ones.

Additional Benefits of Day Trading

- Traders get to control their day and determine their trading hours. There is no boss telling them when to work and when to take a break. This kind of freedom can be very liberating.
- Traders can work from the comfort of the home office. A home workstation is an ideal place to work from. There is no need for hiring an expensive office and dressing up to go to work.
- There is no need to receive formal training like they do at college or through a tutor. Day trading can be learned informally through online lessons or from other traders. Formal training is generally not mandatory.

- CONS

Day trading does have some negatives. For instance, one of its low points is its inherent risk. Day trading is a high-risk venture, and plenty of newbie traders, novice and beginners lose money. The reason is that they lack the kind of market understanding as well as experience. However, with time, the dedicated ones are able to turn

their fortunes around and trade profitably. It is advisable to understand that there is no guarantee for profitability. According to the US government's regulatory body, the SEC, most new day traders lose significant amounts of money before they eventually turn their fortunes around.

Costly

Another major disadvantage of day trading is that it is a very costly venture. Traders need access to large amounts of capital in order to be profitable. For instance, a trader needs access to about $100,000 as trading capital or even more if they are to make significant profits. Accessing such huge amounts of cash is not easy for the ordinary trader.

Taxes

Another challenge that is likely to come into play is the issue of taxes. Traders sometimes incur capital losses and then later acquire capital gains. Such gains are highly taxed at rates equivalent to personal income rates. There are also other costs to think about, such as commissions payable to the broker and payment for additional services such as analysis, access to data, and so much more. These costs can, in some cases, be prohibitive.

Risk Capital

Another crucial yet notable aspect is the need for traders to have an amount known as risk capital. This is a cash amount that traders are able to lose when they enter trades. This is generally an additional amount that most traders may not be able to access. Risk capital is a requirement by most brokerages. The Securities and Exchange Commission has another requirement that all traders have a reserve amount of $25,000 in their trading accounts. This applies to traders who intend to enter the markets for trading purposes at least four times in the course of a trading week.

Reliant on Market Activity

Unfortunately for traders is that their success largely depends on market activity on any given day. When there is significant market activity coupled with large volumes and volatility, then the conditions will be rife for profitability. However, when the markets

are quiet with little movement, then chances of making significant profits diminish significantly. This is especially disheartening considering that some standard costs such as commissions have to be paid.

High Chances of Failure

Day trading is not for the soft at heart. It has a steep learning curve, and new traders may incur significant losses before their fortunes experience a turnaround. Traders need to develop a good working strategy and ensure they understand the markets and how they function. Discipline is also essential so that traders avoid letting emotions influence your decisions.

Additional Cons of Day Trading

- Traders need to be prepared to take risks. However, not all risks are worth taking. This is why traders need to learn how to assess and then handle any risks. Risks that are too great can be ignored, but those that seem worthwhile can be taken.
- Most day traders are lonely professionals who lead lives in solitude. This sometimes has an impact on their social and even mental health.
- Some traders are unable to uphold discipline when trading. Discipline is a must for any successful traders. It calls for day traders to develop then stick to a trading plan. Undisciplined traders tend to deviate from this plan, and this greatly increases chances of failure.
- Traders cannot expect to receive a monthly salary or any fixed income. Instead, traders will have to contend with profits one day and losses on another.

Different Types of Securities for Day Traders

There are numerous types of securities out there. In finance, we define security as a financial asset that is tradable. This means the financial asset can be traded, bought, or sold, at the financial markets.

Securities are crucial for the global financial system. They are financial instruments that are created to afford their owners a variety of options. This means anyone with a financial instrument

can sell, purchase, hold, assume or relinquish ownership, and so much more.

There are certain securities that are traded more than others. Day traders generally prefer certain securities. These include stocks, currencies, and contracts for difference. Others are futures contrasts like commodity futures, currency futures, interest rate futures, and equity index futures, among others.

Securities

Securities are financial instruments that are traded on exchanges around the globe. Some of these popular exchanges include the London Stock Exchange, New York Stock Exchange, and exchanges in cities such as Hong Kong, Tokyo, Paris, Sydney, among others.

Some securities such as bonds and other fixed-income assets are traded across the secondary markets. There are millions of individuals around the world who hold various securities, especially stocks, bonds, and others. Other entities include exchange-traded funds or ETFs and mutual funds.

Before security is made available to the public, it has to be vetted. Large firms and corporations that wish to list at the stock market in order to raise money for different purposes have to be assessed by the regulator. In the US this regulator is the SEC or securities exchange commission. The stock and bonds markets are also referred to as capital markets. Companies that need to seek funds from the public list at the markets so that individuals and institutions purchase their stocks and then trade them back and forth whenever they want.

Large companies have to liaise with investment bankers and underwriters to help in the preparation of listing their securities at the markets. These securities could be bonds, stocks, and so on. The investment bankers will generally examine the company's financial position and the amount it intends to raise. It is based on this that the firm will likely recommend the number of shares or securities to be issued and how to approach the entire listing process.

Securities

Stocks and bonds are generally the most common and best-known

types of financial securities available. They are also the most commonly traded securities together with a few others. However, they are not the only financial instruments traded at the capital markets. We also have options, derivatives, indexes, currencies, warrants, and debentures, and even US treasury securities.

All these securities have a few things in common. They all carry a certain value that makes them admirable to both traders and investors. This is the reason why they are always trading in the markets. However, the risk profiles of these securities vary greatly. Different traders and investors have different risk appetites. This is why the choice of security to trade or invest in varies.

Take bonds and stocks, for instance. Stocks carry a higher risk level compared to bonds because of how they respond to market fluctuations and the general economic state. Bonds are a lot more stable even though the income they provide is considered fixed.

Stocks

Stocks are by far the most popular form of the security sold and purchased by both traders and investors at the markets. There are different kinds of stocks, such as ordinary shares. These are sold to the public by the parent company through the stock market. Stocks from very successful companies that are profitable over the years are referred to as blue-chip stocks. We also have internal stocks as well as niche-specific stocks. Common stocks transacted regularly at exchanges are also known as equities. The reason why stocks are by far the most popular sort of security traded is that they have the highest return. Stocks on average have a return of 9.2%. In comparison, bonds have seen a return of about 6.5% within the same 50-year period.

Bonds

Another popular security that is common among day traders is the bond. Bonds are ideally a form of investment where investors put their money in debt, either public or private. Therefore bonds are largely considered to be instruments of debt.

Bonds are also known as debt securities, so a trader who deals in bonds is purchasing a debt instrument. Compare this to traders who deal in stocks which are essentially units of ownership of a listed

company.

Companies or organizations that issue bonds often do so to raise money for a certain financial obligation. For instance, governments may issue a bond in order to expand or improve the local infrastructure while companies do so in order to expand into new markets or sometimes even to come up with a new product line and similar ventures.

Banks also issue instruments similar to bonds. These are known as certificates of deposit. Banks issue these in order to receive funds they need most to lend to their customers. Investors or buyers of certificates of deposit often received a certain fixed rate of interest for their investment. Certificates of deposit are short-term investment tools used by banks to raise revenue for their operations.

Options and Derivatives

Another common type of security is a derivative. Derivatives are financial securities whose value is directly related to an underlying security. This means the price is derived from the price of the underlying asset and hence the term derivative.

A good example of derivatives is an options contract. Equity options contracts are contracts between a buyer and a seller regarding an underlying asset. The asset is most cases are most often stocks. Not many retail traders deal in options, but there are numerous professional traders who trade in options on a regular basis. Others include investment firms, commercial and investment banks, hedge funds, and other companies that need to balance their portfolios and so on.

At the most basic level, equity options simply contract that award buyers a right to sell or purchase underlying stocks at a certain price and within a certain period of time. It is important to note that this is a right but not an obligation. The seller, on the other hand, is obligated to sell should the buyer exercise their right. Beginner and novice traders should generally stay as far away from derivatives as possible because they are extremely risky.

Currencies

Trade in currencies is sometimes referred to as Forex or foreign exchange. It involves the purchase and sale of currencies at an exchange. The main aim of currency trading is to make a profit. The gist behind currency trading is the fact that currency prices are always fluctuating and based on these fluctuations, traders are able to capitalize and earn a profit.

There is a reason why some day traders prefer trading currencies. One reason is that the currency market is the largest market in the entire world. This market has a turnover of $2 trillion each and every single day. This is massive even when compared to other large securities markets such as NYSE.

How to Select Day Trading Stocks

Day trading is a trading strategy that involves sale and purchase of financial security. This is done over and over during the course of a trading day so that eventually the trader earns a decent amount of money.

Most day traders are institutional traders because they have the necessary funds and resources to leverage the markets and increase profitability. However, there are also numerous traders across America and numerous places all over the world, especially with the advent of the internet and remote trading. Most brokers prefer online trading, which makes it easier for traders regardless of their locations. It is also easier for brokers because most activities are automated.

Finding Best Stocks to Trade

A trader first needs to take stock of their own situation. There is not a single approach that is suitable for every trader; therefore, a trader should identify a stock or financial instrument that fits their personal circumstances and is in-line with their personal goals.

This means considering the financial position, especially the number of funds available for trading. Traders also need to consider buying a security in a field or industry that they are familiar with. For instance, an accountant may be happy trading financial stocks while an engineer will be at home with tech stocks, and so on. Such considerations will ensure you understand what is going on in the industry, and this will boost trading ventures.

Traders also need to find securities that are highly liquid and trade in large volumes. There is a reason for this. When a security is trading in high volumes, then it is easy to enter and exit positions. Also, highly liquid securities make it easy to get paid upon exiting a position. Some of the best financial securities that have large volumes and are liquid are blue-chip stocks. These are stocks of highly valued companies that are constantly making large profits, are stable, and considered very valuable.

Stocks that are highly liquid tend to be more easily traded and are easier to discount compared to many others. Also, stocks and securities from firms with large volumes of shares traded tend to be more favorable. Traders should take the time to conduct analysis in order to find which stocks are most suitable. A good stock is one from a large-cap company rather than a low cap firm. This is because it is easier to find buyers of large volume stocks compared with buyers for low volume stocks.

Some of the best instruments are highly volatile ones. Volatile stocks and securities provide day traders a chance to capitalize on the rapid and numerous price changes. Remember that day; traders make most of their money due to the rapid or frequent price changes. As such, stocks that are constantly moving up and down or are volatile are much better and preferable compared to less volatile ones.

We have what is known as the TVI or trade volume index. This is a measure of the volumes of a particular stock that is trading at the market. Using this index, traders can determine whether or not to choose the particular stock. TVI indicates the total amount of cash that is following into and out of stock. The volume gives a clear indication of the stock's activity at the markets.

Another crucial aspect to consider when selecting a stock is the industry. One of the best industries for day traders should be the financial services sector. This sector is excellent because it features most of the above factors like large volumes and volatility. A great example, in this case, is Bank of America. This is a well-established bank that is well known and with a positive reputation.

It also happens to be one of the most highly traded stocks and is preferred by most day traders. It is definitely an excellent choice for

day trading forays as it exhibits all the desired characteristics. Bank of America is a large corporation, it trades a large volume of shares each day, its stock is volatile, yet the bank remains stable and profitable through the years.

One important point worth mentioning is that a day trader should never let emotions take charge of trading activities. This means coming up with a trading strategy and plan and then implementing it to the letter. All too often, traders either become greedy or despair and then begin trading guided by their emotions.

For instance, they refuse to exit a winning trade instead of collecting profits first. In other cases, traders choose to continue incurring losses beyond the stop-loss point. These are dangerous attributes and are common among new and novice traders. It is a practice that should be shunned at all costs for successful and profitable day trading.

Day Trading Styles

We have noted in the previous chapter that day; traders execute trades in the course of a single day while investors buy stocks and hold on to them for years. Now in between these two extremes are other forms of trading. These include swing trading and position trading among numerous others.

Swing trading is where a trader buys an interest in a commodity or stock and holds the position for a couple of days before disposing of it. Position trading, on the other hand, is where a trader buys a stake in a commodity or stock for a number of weeks or even several months. While all these trades carry a certain element of risk, day trading carries the biggest risk.

A trader with the necessary skills and access to all the important resources is bound to succeed and will encounter a steep learning curve. Professional day traders work full time, whether working for themselves or for large institutions. They often set a schedule which they always adhere to. It is never wise to be a part-time day trader, a hobby trader, or a gambler. To succeed, you have to trade on a full-time basis and be as disciplined as possible.

Common Markets for Day Trading

Every trader needs to spend some time to decide which market to participate in. A lot of day traders often participate in one or two markets only. By specializing this way, they are able to become intimately familiar with the market and all its ups and downs. By becoming familiar with one or two markets and how they perform, traders are able to make better decisions and hence improve their trades.

Some of the common day trade markets include;

- the stock market
- the Forex market
- financial futures market

The Futures Market

A futures contract can be defined as an agreement between a trader and a seller to participate in a particular trade at an agreed price at a future date. Most futures contracts include commodities such as textiles and fibers, oils and fats, grains, energy products, electronics, metals, steel, skins and hides, and so on.

Here is how Futures Contracts Work

Imagine you are a grain farmer with corn almost ready for harvest. You still have a couple of months before harvest. At harvest, you will sell your crop at today's price of $5 per bushel and make a tidy profit. But if the price drops to about $3.50 before you sell, you could suffer a loss. With this kind of situation, you could enter into a future contract with a cereal manufacturer or any interested buyer and sign an agreement to sell your corn at $4.75 per bushel. The futures contract guarantees you a profit regardless of how the markets will be at harvest time.

This is the very same principle that Futures trading operates on. The only difference is that they are based at some of the leading exchanges like the NYSE and feature on top indices like the Dow Jones Industrial Average and the S&P 500. Day traders dealing in the futures market is simply betting that a particular index such as the Dow Jones will get to a certain level at a particular date in the weeks and months to come.

The Forex Market

Many day traders also operate at the Forex market. Traders at these markets usually trade in foreign currencies such as the Hong Kong Dollar, Yen, Euro, Dollar, and many others. The purpose of foreign currency trade is to profit from the differences in exchange rate because the rates vary throughout the day.

The Forex market is popular with day traders, mostly because it is huge in size and offers plenty of opportunities to profit and earn a reasonable return. Forex markets are available and open for trade 24-hours a day, six days of the week. In order to make a significant profit, traders will need to leverage as the price movements are rather small.

The Stock Market

The single most popular market for day traders is the stock market. A lot of the traders on the stock market often deal in stocks that are listed in one of the major indices such as the NASDAQ or the DJIA. NASDAQ is one of the largest indices in the market and features almost 32oo firms on the New York Stock Exchange. Most of these are technology stocks from relatively small firms. Their speculative nature makes them very volatile stocks. It is this volatility that makes them an attractive target for day traders as they can capitalize on it to make money.

Volatility: One of the crucial factors that are essential for successful day trading is definitely volatility. It is a measure of the price variation of a stock over time. It is thought to be high if the variation is high. A stock that is highly volatile is attractive because its price variation throughout the day provides an excellent chance to capitalize on this movement to earn profits.

Liquidity: Also, an important factor for all day traders is liquidity. It is essentially a measure of the ease with which an asset, commodity, or security can be purchased or sold. It is important that day; traders only choose liquid securities because such assets are heavily traded throughout the day and can easily be converted into cash at the end of the day.

Day Trading Strategies

1. Bounds Day Trading

Bounds day trading, also known as range-bound trading is a day trading strategy that aims to spot and make use of securities that are trading within the price channels. Day traders can purchase securities at the bottom of the channel or lower trend line support if they find major resistance and support levels that can connect to any horizontal and parallel trend lines.

For this strategy to be successful, then it is important that a day trader identify areas of resistance and support then connect reaction lows and highs with any horizontal trend lines. To maximize on this strategy, a trader will repeatedly purchase a security at the support trend line and later dispose of the security at the resistance trend line.

Range trading is preferred by traders as they can continuously purchase securities at the support trend line then dispose of them at the resistance line until the stock actually makes a break from the price channel. The thinking behind this strategy is that the stock price is probably going to rebound from the levels and not break through them. In such instances, the risk to reward ratio is always in the traders' favor.

It is advisable to set up a stop-loss control. When it comes to range trading, the stop-loss points are located right above the lower and upper trend lines. They are placed there to help protect against significant loss should the price start trending downwards.

An example

Supposing security has an upper resistance at $25 while the support line is at $20. The best approach would be for a day trader to purchase the security at $21 shortly after a rebound and then place a stop-loss at $19. The trader will be well protected should the price start to fall beyond the trend line.

In some cases, day traders borrow money and use the borrowed funds to benefit from price movements at the market. They use borrowed funds to purchase stocks at low prices and hope to then sell these at higher rates and make a profit albeit small. In fact, day traders are constantly buying and selling stocks or securities. They rely on these small and minute profits that they make throughout the trading day. At these end of the day, these can add up to a

decent amount.

2. Stock Day Trading

Day traders top security choice is stocks. It is important that a trader be well versed in the intricacies of the stock market and also acquires plenty of information happening in politics and the financial world. There are certain important aspects that should be kept in mind.

Ensure that you avoid penny stocks. They are never liquid enough, and it is not possible to make any money off them. It is advisable to start small if you are a beginner. The best approach when day stock trading is to start small and trade just one or two stocks daily. This way, you will learn the ropes, intricacies, and tricks and also grow your experience.

3. Forex Day Trading

Forex day trading is also known as intra-day trading. This strategy basically entails the buying and selling of foreign currencies. It also means that trades are opened and closed on the very same day. These kinds of trades are essentially full of action, so traders need to be present during the entire session.

Risks are often high when it comes to Forex day trading, so traders have to be alert at all times. Forex day trading rules are quite harsh, so close attention has to be paid when trades are made.

Chapter 3:
Best Day Trading Tools and Platforms

Day traders need to have access to some of the best trading tools if they are to trade successfully and be profitable in the long run. In fact, to be effective, traders need a combination of facilities including tools, services, platforms, software, and information, among others.

A lot of new or novice traders use the wrong tools a lot of the time. It is crucial that traders learn about the useful tools that they need to use. Traders that do so tend to enjoy a lot more success than those who do not. Skilled and experienced traders are sometimes able to trade without the latest and most advanced trading tools. However, beginners, novices, and even intermediate traders should always use these tools. Having access to these tools means a trader is well equipped to handle the trading process in the most convenient and efficient manner. It also means having access to the best charting software, scanning software, and even trading platforms.



Using the right tools is important, especially when viewed from a certain angle. Think about someone riding a $2,000 bike on the sand. No matter how great the bike is, it is almost impossible to ride comfortably on a sandy surface. A rider with a $500 bike on a tarmac road will fare a lot better. This is the same issue when it comes to day trading. A day trader should have access to the right kind of tools. Not all tools available are necessary, and therefore, the need to have the proper tools is essential.

Best Day Trading Software

There is a saying that has been around for a while. It states that a trader is only as good as his charting tools. This statement underlies the importance of high-quality trading tools, including charting tools and software.

Most traders already have some of the most crucial trading tools. For instance, trading is often conducted online and electronically rather than manually and in-person. This is why the average trader already has a computer as well as connectivity. Having a phone nearby is also advisable. Sometimes a call may be necessary to call and obtain important information. Here is a look at some of the crucial tools that all active day traders need.

Crucial Tools for Day Traders

There are certain tools that are essential to all day traders. These include hotkeys, fast execution, and access routing. These are best sought out from brokers. There are different kinds of brokers out there. Most of them specify in different niches such as currency trading, stock trading, and so on.

1. Stock Scanner

One of the tools that a day trader must have is a tool that scans stocks and conducts a background test on each one so as to provide detailed information about all. A good example of a stock scanner is Trade-Ideas. A good stock scanner is important, especially if it has artificial intelligence capacity. Trade-Ideas produces a continuous flow of ideas that can be used to come up with a strategy. Remember that the first stage of any trading process is identifying the best security to trade. There are certain characteristics that this stock is supposed to have, including volume, a stable and profitable firm, volatility, and so on. Trade-Ideas is able to scan through thousands of stocks and other securities and provide a list of suitable stocks.

TI has about 50,000 regular users, most of whom are day traders. These users are spread out across 19 countries. Trade-Ideas is excellent stock scanning software that is used to observe volume spikes, market movers, the biggest losers, biggest gainers, and all other important metrics.

2. Hardware

A pc or laptop computer is another essential piece of hardware. A modern, new PC or laptop that is not more than three years old is great because technology is fast changing. It is advisable to have a computer with sufficient internal memory and a superfast processor so that it does not slow down, crash, or hang while processing information.

It is advisable to purchase a good quality computer that has all the important software programs. It should be able to process data really fast and can connect to the internet.

3. Telephone

Sometimes the internet is unavailable, and other times there is a need to make a phone call. This is where a phone comes in handy. If there is a need to urgently contact a broker, then the phone should always be an option. Traders should have their brokers' phone numbers close by so they can be called anytime the need arises. Sometimes it may be almost impossible to access the internet, and the computer may even crash, making it impossible to contact the broker except via the telephone.

4. Charting Software

Traders can find most of the trading and charting software on a broker's website. Brokers provide certain tools that traders need in order to monitor closely the price charts and to trade effectively. The best approach is for a trader to find and use software that enables to speedily and effectively put up different charts so they can check them out at any time as they trade.

There are different kinds of charts available, and some traders prefer having a wide variety of these, including timed charts and tick charts. These tick-charts come in different calibrations such as the 5-minute chart, 20-minute chart, one-hour chart and so on. Day traders need the best charting software as well as the best trading software for best outcomes.

One of the best charting software applications available today is Ninja Trader. This is an excellent software program widely used by traders because of its excellent features. It can be used in different ways. For instance, on some brokerage platforms, it acts as both a charting software program and a trading platform while on others it

is only a charting software application.

5. Trading Software

The most crucial tool that day, traders need more than any other is trading software. Good, modern, easy-to-use trading software is a trader's best friend. Such software is normally found on broker's platforms. As such, it is crucial to find reliable brokers who take their time to update their platforms and install the latest software programs for traders to use. It is actually advisable to check out a broker and find out about all what they have to offer before actually signing up. This means checking out the platform and the trading software available.

6. Internet Access

It is important that traders ensure that there is access to fast, stable, and reliable internet at all time. Stable internet is crucial as traders need to enter and exit positions at certain precise moments. If this cannot happen because of poor and unreliable internet, then there'd be serious trouble, and a trader could lose a lot of their trading capital.

Quality and stable internet should be able to sustain reasonable speeds and support steady streaming of data without lagging. If this is not possible, then another provider can be sourced. Generally, cable internet is preferred over DSL or mobile internet. It is a lot more stable and reliable.

It is also advisable to have backup internet just in case. While a single reliable provider is great and is awesome most of the time, there will always be moments of failure. It is advisable to get an additional provider even if this might cost a bit more. One great way of achieving this is by getting a Smartphone. A good smartphone with internet access can save you lots of pain when the occasional internet slowdown or downtime happens.

Day Trading Tools Examples

Trade-Ideas

One of the best-known tools for analyzing stocks for trade is Trade-Ideas. This is a very powerful stock scanner and hence its popularity. According to seasoned traders, this is the best scanner in

the market today and does a splendid job. It is used even by seasoned traders and professionals who have years of experience.

What this tool does is search across thousands of different stocks to identify them and compile essential statistics and then display the outcome in a manner that is easy to follow. Traders receive alerts that enable them to take the necessary follow-up action. This way, a trader can easily determine which stocks to ignore and which ones to include in their trades on any given trading day.

Most traders already have some of the most crucial trading tools. For instance, trading is often conducted online and electronically rather than manually and in-person. This is why the average trader already has a computer as well as connectivity. Having a phone nearby is also advisable. Sometimes a call may be necessary to call and obtain important information.

Trading View

Another crucial tool that is of benefit to traders is Trading View. This is analysis and charting tool that is available in both free and paid up versions. Traders can use the free version, but the paid one definitely features a lot more options which can come in really handy.

This software tool makes it very easy to view numerous price charts and also keeps track of various asset classes such as currency pairs, commodities, stocks, futures, and cryptocurrencies. It is possible to use this specific system to scan multiple assets all at the same time, which means traders are not limited in their scanning and search endeavors. Traders are also able to search not just local markets but international markets as well.

This platform accepts payments in the form of bitcoins, is customizable, serves as an excellent source of information and news, and features a calendar with a clear display of major events.

Additional Day Trading Tools

It is important to have unfettered access to the right day trading tools of you are to trade successfully. Skilled traders are able to manage fairly well with limited resources. However, newbies and inexperienced traders should have proper trading tools if they are to

earn a significant profit. This simply means having access to the most suitable trading software. It also means having access to tools such as charts, news, and so on. Some of these are listed below;

- Earnings news calendars
- Forex news calendars
- Position sizing calculators
- Trading journals
- Financial news
- Forex trading tools

Earnings News Calendar

One of the most crucial trading periods for any trader is the earnings season. These seasons occur four times each year, and it is when listed companies report their performance in a given quarter. Traders know earnings periods to be very volatile. It is very important that traders are not caught up in trades because anything could happen after the reports are out. Losing huge chunks of money is a very real possibility. The best advice, therefore, is to let the dust settle first before trading during this very volatile period.

Financial News and Information

Day traders normally begin each trading day with a review of news and specifically business and financial news. A review of the stocks flickering on the trade scans provides plenty of ideas and useful information. The news catalyst is often an item in the news that causes stocks to rise or dip. Earnings reports are a good example of why stocks may be volatile in a given period of time.

There are a good number of tools that can help search and scan news across the web and other platforms. The aim is to identify the reasons why stocks are moving in one direction or another. Staying up to date with the news is crucial for successful trades. Tools such as Benzinga Pro and Radio provide the latest information and news on the performance of stocks across different platforms. Breaking News is yet another useful tool that provides information on the latest news from the markets.

Other sources of useful news that all traders should have to include the New York Times, Bloomberg, Reuters, Market Watch, the Economist, and a couple of others. All these and other news portals

provide the latest financial news essential for a successful trading day.

News Feeds are subscription based tools that provide fresh news that could affect stocks and shares at the markets. Day traders benefit in many ways when they sign up for these news feeds. PR Newswire, Dow Jones Newswire and others. It is basically very easy for day traders to waste plenty of time trying to find news and hence the need for the new tool.

Position Sizing Calculators

Another extremely useful tool used by traders is the position sizing calculator. This tool is mainly used in the management of risks and helps protect a trader against losing substantial amounts of money. Correct position sizing is the best way to identify risks and mitigate against them.

Order Execution Tools

Day traders use certain tools to place orders in the market. Traders spend their times reading charts and making analysis. Once they determine what trades they will enter, they then make use of order execution tools to execute the trades. Such tools not only make basic orders but also additional orders such as additional buy orders, stop-gap, and so on. The orders can be specific and will be executed as per the orders or wishes of the trader. Hot-keys are often used for such purposes. These hot-keys help save time and make order executions a pretty simple process. Having such tools make it easier to take advantage of market situations to place profitable trades.

Fundamental Research Tools

Day traders also need unfettered access to research tools. Research is absolutely essential for effective and profitable trading. Fundamental research tools come in handy and help traders to easily look up useful information and pertinent details about any company that trades at the stock exchange. Research using these tools will provide useful details, including the latest and past earnings information, financial metrics and reports, and even analysis ratings.

Some of the latest, more modern research tools have a lot of sophisticated features that make access to essential information faster and more reliable. Such tools do not just provide the information wanted but also make trading easier, faster, and more convenient. Having all this kind of information and in formats that are easy to assimilate and understand is much better than having to search across different websites on the internet.

Trade, Technical, and Customer Support

Some traders may not be aware of this, but having access to good customer service is also essential. And not just customer support but generally, having access to trade support, technical assistance and even administrative support are absolutely essential. Traders get stuck numerous times when executing their trades or even operating particular software. Some of the time, they could do with help. Having access to support via email, internet, or telephone is absolutely important. However, even these can be slow, especially when placing or entering trades. Having the ability to consult the help and ask a question and seek assistance is essential, and this is always the norm on most trading platforms.

Screeners

As a trader, you will need to determine the particular stocks you will trade in. for this, you will need to use screeners. A screener is simply a filtering tool that helps you identify stocks that you can trade in. You need to ensure that you find a screener that s able to filter out all the parameters you desire. A filtering criterion that you need should be on board.

For instance, if you have a trading strategy that incorporates the 150-day moving average, but your screening tool does not have this provision, then you should try and find another one. Screeners help you to zero in on a particular stock if you have hundreds of potential stocks.

A Watch List

One of the best ways of tracking potential future trades is by creating and maintaining a watch list. This is easy to do online because there are plenty of trading sites offering the service. It is even possible to integrate the service with a trading platform. You

do not have to pay for this service because it is essentially just a list of stocks. You can easily find software that you can use to create your own list. Once you have prepared your own list, you can then organize it and manage it any way you want. You can even come up with a sub-list. As a rule, you should maintain a list and try and ensure it is independent of any websites. This is because those offering the service charge for it and are sometimes unavailable.

Back Testers

Historical market data is normally used to test a trading strategy by back testers. These are often websites designed for this very purpose. Some are more sophisticated, but most are limited in their functionality by the prevalent preselected criteria.

At other times, testing is restricted to a given data set. However, the more sophisticated back testers allow you to define your own data set and even draft your own script. A lot of traders skip this step, but if you have a complex swing trade strategy, then it is advisable to use the backtest to confirm that it will work as desired.

Day Trading Platforms

Introduction to Trading Platforms

Trading platforms can be defined as software designed from entering and exiting trades at the stock markets. The software enables traders to manage positions, open and close them on behalf of a trader. This is often performed through an intermediary such as a broker.

Today, most day trading platforms are online and are a service provided to traders by brokers at a fee. Sometimes the services are available at a discounted rate, especially for active, long-term traders.

Trading Platform Basics

Trading platforms enable traders and investors to access the stock market and place different trades. Traders can purchase or sell all kinds of securities, such as currencies, stocks, futures, and options. However, most brokers tend to specialize in a given security. For instance, a broker may wish to provide options trading only to clients. This way, clients will then sign up to only trade in this

specific security.

There are generally two distinct types of trading platforms. We have commercial platforms, and then we have the prop platforms. Commercial platforms are more suitable for retail investors and day traders. These are often simple to use, easily accessible, and come with numerous additional features that make investing and trading much easier. These additional features include charts and news feeds amongst others.

We also have prop platforms which are customized to suit the needs of clients who can afford the cost of customization. Such clients are usually large brokerage firms and other organizations where professional traders have certain specific needs. The development is undertaken by brokerages together with software developers in order to meet the needs and trading styles of large professional traders.

There are certain considerations that need to be made when determining the most appropriate trading platform. Traders need to consider things such as fees charged, features provided, accessibility, customer service provided, and other crucial matters. Some traders are more focused on customer service and access to the broker while others prefer platforms that are easy to use and come with a variety of features.

As a day trader, you will most likely be using commercial platforms provided by different brokerage firms. Even then, there are some things that you need to be on the lookout before choosing one. For instance, what are the included features? How about costs and fees charged? Also, different traders will require different tools on their platforms. There are certain tools that are suitable for day and swing traders, while others are more suitable for options and futures traders.

When selecting a platform, always watch out for the fees charged. As a small-scale, retail day trader, you want to trade on one that charges low and affordable fees. However, sometimes, there are certain trade-offs. For instance, some platforms charge low fees, but they lack certain crucial features or provide poor services. Others may seem expensive but provide crucial features, including research tools and excellent services. So you will need to consider all these

factors before eventually selecting a suitable trading platform.

There is another crucial point to keep in mind when selecting a trading platform. Some platforms are available only through specific brokers or intermediaries. Other platforms are universal and work with different brokerage platforms and intermediaries across the board. Traders also select trading platforms based on their own personal styles and preferences.

You should find out if there are any particular requirements or conditions that require to be fulfilled. For instance, some platforms require traders to maintain at least $25, oo0 in their trading accounts in the form of equity and possibly cash as well. In this instance, a trader may then receive approval for credit, which is also known as margin.

Examples of Day Trading Platforms

1. The Home Trading System

The home trading system is an algorithm and trading software designed to improve performance. Using this system, you can expect to make smarter, faster, and better trading decisions. This particular platform comes with innovative features and a custom algorithm that combines seamlessly to provide a real-time, fully integrated trading platform. You are bound to benefit from this platform and experience the benefits of seamless trading complete with all the features that you need.

The platform is completely compatible with some of the most dynamic and highly reliable charting tool. It is able to work with all kinds of markets, from stocks to Forex and indices. The platform is compatible with a variety of bars such as range and momentum bars as well as tick charts.

The designers of this platform took great care to consider all the different kinds of traders. This is why this specific platform is suitable for day traders, swing traders, Forex traders, retail investors, and long-term traders. The Home Trading System constitutes a modular platform that consists of different core features. A lot of these features can easily be switched off and on depending on the situation or to suit a particular requirement.

One of the advantages of this platform is that it endeavors to make trading extremely simply. For instance, the algorithm automatically colors the candlesticks or bars a red or blue color in order to provide a clear view of the market conditions and trends. The system will continue following the trends and mark any major changes in a contrasting color. For instance, whenever there is a trigger bar, these will appear in a different color so that it is clear to you the trader that there is definite variation in the trend.

This color feature not only makes trading easy but also improves your trading psychology so that you can trade with very little worry. Other desirable parameters that are essential to your trades are also provided on the platform. For instance, you need accurate and reliable trading signals delivered at the right time. Fortunately, the Home Trading System is designed to provide these signals in a timely and accurate manner.

When there is a turning point in the momentum of stock in the markets, then this will be detected, and a change of color will clearly indicate the turning point. You will be able to see a blue color with contrasting orange color pointing out areas of interest. The dots will indicate the entry points, exit points, collect profit points, and so on. A stopping point is also indicated just in case the trade does not work out as planned and you need to exit.

2. The Entry Zone Platform

We also have a trading platform known as the Entry Zone. This platform has been around for a while but has recently undergone a complete overhaul. It has received a new design to specifically address the needs of day traders. There is no trader in the entire world who wants to join an over-extended market even when it features a large stop-loss point.

One of the main benefits of this platform is that it helps eliminate the challenge of entering an overly extended market. It starts by first checking for a pullback. It does this by accessing the 60-minute timeframe. This way, you will be protected from accessing the markets at the worst moment. The algorithm is able to proceed and track the markets so that you eventually get to find out the best market entry points.

3. Able Trend Trading Platform

This is another platform designed with day traders in mind. One of its most outstanding features is its ability to instantly identify changes in the trend. Trend direction is first indicated by a distinct color. When the signal is headed upwards, then the color is blue, and when it heads downwards, it changes color to red. If there is any sideways movement, then the color changes once more to green.

This platform, therefore, makes it pretty easy to observe the market trend and keep abreast with it. Additional information will then enable you to make the necessary trade moves that you need to as a trader. For instance, you will notice red and blue dots on your screen. These indicate the various stop points. When there is a downward trend, then the red dots will indicate your sell points while blue dots will indicate your buy points on the upward trend. These stop points ensure that you partake of the large market movements but with very little risk or exposure.

The reasons why this system is so successful is that it comes with state of the art features. It generates dot and bars colors that you can choose for the different bar charts. These include the 5 minutes, 1 minute, daily, tick, and weekly charts. Many traders have termed this platform as both robust and functional. It is a universal platform that can work with different trading systems.

You can make large profits if you can enter the markets and join the trend at an early stage. Identifying the trend is easy when you have this software. Remember that the trend is a friend of day traders. Therefore, spend some time at the beginning of your trades to identify the trend and then move on from here. Identifying the trend at an early stage is what you wish to do. The risks to you are minimal at this stage. This platform helps you identify the trend and provide you with additional crucial information that even large investors do not have.

You can operate in any market so that you are not limited to trading stocks only. If you wish to trade in options, currencies, and other instruments, then you are able to do so. The platform is suitable for all trading styles, including day trading, swing trading, and position trading, and so on.

4. Interactive Brokers

This is a popular platform that has been recently revamped. It is highly rated software because of the useful tools available to traders. Some of these tools are extremely useful to sophisticate or seasoned traders who need more than just the basics.

This platform is able to connect you to any and all exchanges across the world. For instance, you may want to trade markets in Hong Kong, Australia, and so on. The software is able to seamlessly connect traders so that you have great trading experience.

This platform has seen the addition of new features which make trading even easier. These are, however, more suitable to seasoned traders who are more sophisticated than the average retail investor or small trader.

One of the attractive features of Interactive Brokers is that it is a very affordable platform. It is especially cost-friendly to small scale traders, retail investors, and the ordinary swing trader as the margin rates are low and affordable.

The platform supports trading across 120 markets located in at least 31 countries and deals in more than 23 different currencies. It also supports traders who execute trades pretty fast.

Additional Considerations

Before selecting your preferred trading platform, there are certain things that you will have to think about. For instance, what is your account size? In other words, how much funds do you have in your swing trading account? The answer to this question will help you narrow down your choice of platform.

Some platforms are designed for specific financial products like options trading, day trading, currency trading, and swing trading, and so on. As a trader, you should find out if a platform is compatible with your trading style. Therefore, always have the product in mind. Geography is also a consideration is come cases because some platforms are only available to traders in certain jurisdictions and not others.

A strategy is also crucial. As a day trader, your strategy is to buy and hold for a couple of days or weeks. There are crucial factors

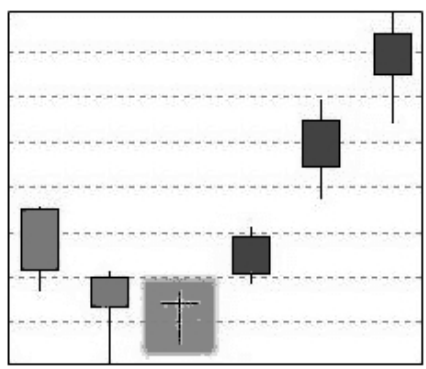
that you need to consider, even as you choose a trading platform. For instance, how much automation do you require? Are there any manual functions that are necessary? How about risk management? What kinds of management approach do you desire to cut losses and lock profits? A good level of functionality is definitely necessary.

There is also the issue of cost that you have to consider. As a trader, you can expect to incur some costs. Generally, if you are a regular trader trading in stocks, then regular platforms will do just fine. However, should you require something specific such as a personalized platform then you will probably have to pay extra. Try and work with what is readily available rather than finding cool add-ons that may not be necessary at this point in time.

Chapter 4:
Day Trading Strategies

Day trading is defined as the process of purchasing and selling securities all within the course of a trading day. Traders buy securities, whether stocks, bonds, or futures, and then sell them before the end of the day. Day traders never hold positions overnight. The reason is that they fear overnight activity could harm their positions and hence the need to terminate positions by the close of the trading day.

Day traders look to benefit or profit from tiny movements in the price of the instrument they are trading. Stocks, for instance, are volatile and experience brief but rapid movements throughout the day. These movements can be a reliable source of income for traders. However, if not careful, they could pose a futile challenge to inexperienced traders. In essence, day traders in engage in high volume trades in the course of the trading, and that is where profitability comes to play.



However, it is crucial that only experienced traders engage in high volume day trading as a strategy. This approach is not suited for all day traders. Novice and beginners need to practice more and trade more before they can engage in such a strategy.

Basic Principles Governing Day Trading

Knowledge really is power when it comes to day trading. Traders need to assume the responsibility of understanding day trading, how it works, the terminology used, and all that pertains to trading successfully. A trader who is insufficiently prepared for the markets

or the trading floor should keep off until they can trade properly. Otherwise, they will be inefficient, and the chances of losing money are extremely high.

A good trader needs to always be up to date with the latest news and current happenings in the worlds of business, finance, and sometimes even politics. Information sources include print and electronic media as well as online sources such as mobile and internet. Other items of news that could be of interest include earnings reports, the federal government's interest rates announcements, and the general performance of the economy.

Traders need to have access to sufficient amounts of funds which will be used for trading purposes. While there are no minimum amounts set, a successful trader should have access to at least $10,000 even though the more, the better. Amounts ranging between $100,000 and $500,000 are considered reasonable for attractive returns. Remember that day; traders need to have a security deposit amount of about $25,000. This amount is kept as security just in case anything happens.

Day traders should start small. This enables novice and especially beginners to get the feel of the market and experience the markets. Understand the operations and mechanics of the securities markets is essential if traders are to gain the experience and expertise or skills needed. Small start with plenty of learning and observation is the best way to begin day trading.

Another crucial aspect of day trading is that beginners and novice traders will be better off trading just one or possibly two stocks per session. This way, they will be able to focus better on these few traders and keep an eye out on the crucial aspects such as price movements and so on.

Day traders should avoid penny stocks as much as possible. Penny stocks are low-cost stocks, which makes them attractive. However, they are not liquid at all. This means that it is very difficult to enter and exit positions at the markets hence their unsuitability. Remember that the ideal stocks or securities for day trading need to exhibit certain characteristics. These include volume, volatility, and liquidity.

Techniques for Day Traders

Day traders usually employ a number of techniques and strategies in order to maximize their profits. There are a couple of strategies out there that have been tested over time and proven to be effective. Apart from the strategies, there are also important techniques that need to be discussed. These are short selling and leverage.

1. Leverage

The term leverage in trading simply means the borrowing of funds from various sources with the hope using the funds in day trading activities. Borrowing money to make more money is a technique that has been used by day traders for ages. The main source of funds is usually brokerage.

Brokerage firms often lend leverage amounts to their clients via a specific account, often referred to as a margin account. This account is set aside from the trader's other accounts. It often requires an initial deposit amount to the tune of $2000 or more depending on the terms of the brokerage firm.

2. Short selling

This term refers to selling shares that you do not own in order to make a profit with the hope that the price will fall and you can buy them back again. First, a day trader will identify security or stock whose price is in decline. He asks the broker to borrow the shares. The borrowing is approved, so the day trader sells them at current market rates. As the price keeps dipping, the trader then buys them back and pays a commission for the loan.

Both short selling and leveraging are risky techniques and should only be practiced by seasoned traders. They require discipline and market knowledge because is something goes wrong then the trader could lose out big time. For instance, if the trades do not work out as planned and money is lost, then it will have to be paid back plus commission. To minimize the risks, traders should use tools such as stop-loss measures.

A stop-loss measure is simply in order to have security sold at market price when certain pre-determined conditions are met. For instance, if the price of a stock or other financial instrument drops to a certain amount, then it should be disposed of immediately.

Strategies for Day Traders

1. After Hours Trading

The equities markets in the United States usually close down at 4.00 pm eastern time. Even then, traders continue to have access to the markets until 8.00 pm in the night. Access is enabled via platforms such as ECN and exchanges such as the NYSE. Therefore, trading the markets any time after 4.00 pm till 8.00 pm in the night is referred to as after-hours trading, post-market trading, or extended hours trading. The problem with this trading period is that it is very illiquid as most trading specialists and market makers avoid trading at these times.

The most outstanding feature of after-hours trading is the lack of liquidity in the market. A lot of experts consider this to be risky or even dangerous territory because there is often very little activity. Spreads are often very wide as most of the other traders, especially market makers, have left for the day. Therefore, the securities' activity is often very low. However, day traders know how to benefit from such situations. For instance, if breaking news is announced during this period, then related stocks could have significant action that can be traded.

Trading after hours is tricky due to the illiquid nature of most securities as well as the large spreads. The best time to trade after hours is only when there is a significant news item that affects a particular company or an industry. Such news is best if received during the earnings periods, which occur mostly during quarterly earnings reporting times. This kind of trading should, therefore, be left to seasoned traders only.

2. High-Frequency Trading

High-frequency trading, also referred to as HFT, are essentially programs that execute complex algorithms that can generate super-fast trades across different markets. The purpose of these rapid trades includes arbitrage and market making. The outstanding feature here is the thin profits that accrue from the large volumes of trades initiated. Trades initiated can number in their millions on any given day. It is said that about 50% or half of the volume trades initiated in US stock markets are HFT.

These trades rarely hold a position for long. One of the most useful ingredients in any HFT operation is low latency in order to keep the speed advantage over other traders such as retail traders. It is a modern computer algorithm that power HFTs. If well executed, such programs can generate modest to average profits for a long period of time without incurring any significant losses. There are reports of HFT firms of running for 1000 profitable days without any losses. When everything works as required, then HFT offers a great opportunity to earn plenty of money with very little risk over a long period of time.

Latency: This term actually refers to the time taken for data transmitted between two points to get to its destination. Basically, low latency refers to high speeds, while high latency means low speeds. Most investment companies invest a lot of resources in acquiring the latest, cutting edge infrastructure and hardware necessary for processing trades at high speeds.

Algorithms: These are basically instructions set out which are to be executed once certain conditions are met. A sophisticated algorithm such as the HFC algorithm used in trade has millions of lines of code. In recent years, algorithms have become commonplace, and most traders make use of one type or another to execute their trades.

3. Momentum Trading

Day traders choose momentum trading simply because all the action is on the stock market momentum. This type of day trading aims at profiting from stocks that experience a price gain, especially with huge trade volumes. In momentum trading, stocks and securities are affected by factors such as margin calls, short squeezes, and stop losses, so they move in an excessive and extreme manner. The typical approach by day traders on momentum trading is to scalp profits as quickly as possible and with as much leverage as possible.

Day traders who prefer momentum trading usually trade any security that has large volatility and significant volume. These include securities that have sustained a significant rise in price and are known as high-flyers or momentum stocks. Most of the stocks suitable for this kind of trade strategy are more volatile than those

of major blue chip companies. It is this volatility that attracts momentum traders to these trades. Volatility provides a great option to capitalize and benefit from price movements and volume. Securities with large volumes and high volatility that feature in the news are usually the best suited to momentum trading.

Price movement: This is the hallmark of momentum day trading. Traders often make use of shorter time frame charts like the 15-minute, 5-minute, and even the 1-minute charts. In order to manage risk, the focus should be on the immediate action with large share volumes. It is important for momentum day traders to have precision when entering and leaving the market.

Executions and charts will, in this case, carry significantly more weight compared to the fundamentals of the underlying company. Also, stories in the news carry more weight as news is often the main driver of momentum. Also, chart patterns and essential signals will help determine the best times to initiate trades.

Things momentum traders should look out for

- High probability chart patterns
- Intraday setups
- Volume
- The reasonable risk to reward ratios

4. Options Day Trading

A stock option is yet another trading option commonly used by day traders. Options contracts ideally offer the holder a right with no obligation to sell or purchase an underlying security at a certain price. Options actually are derivatives. This means that their price is derived from an underlying security or even commodity. Therefore, like other derivatives, stock options enable the holder to enjoy the benefits of the price movement of the underlying security, yet the losses they can incur are capped on the option.

A stock options trader basically enjoys the benefits of stock ownership without the obligation or financial implication of having to buy the stock. They only incur costs that are a fraction of the total cost of buying or investing in the stock. Each and every options contract has about 100 shares of the underlying security attached to it. So a trader holding 10 call or put options basically

has control of 1000 shares of the underlying stock.

Many exchanges accept and trade in options contracts. These include exchanges such as the International Securities Exchange, Chicago Boards Options, and many others. This is also due to the fact that their prices move up and down in tandem with the underlying stock. However, options are unlike stocks because they can lose most of their value should their time expire. All options come with an expiry date as this is an inherent aspect they all possess.

How options work

Most of the securities that are widely traded across different markets have options contracts available. This means that anyone who wants to buy call options of the major stocks can do so at any time. The most important features of a stock option are its expiration date and strike price. The strike price simply refers to the price that should be met by the underlying stock in order that the intrinsic value is met. Most options expire on the third Friday of the contract month. For instance, an options contract that is to expire in May of 2018 will expire on the 18th of the month. Therefore, a May 25.50 Call Option implies that the underlying stock should close above the price of $25.50 at the expiration of the contract or at least maintain that price. Once the options expire, they become worthless, and so the whole investment will be lost.

Options Liquidity and Spreads

Options contracts are very similar, in some ways, to stocks. For instance, they have an asking and bid price as well as open interest. In most occasions, liquidity and volume are available within contracts such as ITM and ATM. A tight spread often implies a higher volume and more liquidity. However, blue-chip stocks and those that are heavily traded are likely to also enjoy higher volume and liquidity.

Calls and Puts

There are ideally two different kinds of options. These are called and put options. Now a call option will see its value rise anytime the price of the underlying stock rises. Traders with call options aim to benefit financially any time the price of the underlying stock

goes up. On the other hand, put options tend to see an increase in price any time the price of the underlying stock goes down. Therefore, put options are bearish when profiting as opposed to calling options which are bullish when profiting.

Long and short options

In stock options, long and short positions refer to the exact type of trade and not the direction of the related or underlying stock. It is important to determine if a long position is being sought or a short position. This is because it is essential that a trader determines whether they are interested in the options contract or not. This, in reality, does not necessarily apply to the underlying stock's direction but only the trade being made here with the option.

Options are very different from stocks and so trades in the two instruments. Even then they are similarly traded at the stock markets. Options only differ because they relate to the underlying stock, and holders get to benefit from the same. The most popular way of benefitting financially from options is to use covered calls and be a seller rather than a buyer. In any case, it is advisable to ensure that the options you deal in should be based on stocks or securities that you intend to invest in for the long term. This allows you as the trader to benefit from the options by receiving an income or rent from the risk that you have taken. If you sell options that you do not own, then this kind of position is known as a naked option.

5. Penny Stocks Trading

What are penny stocks? These are stocks trading on the markets that are worth less than $5 each. They constitute some of the most speculative shares in the market, and most of the times are priced at less than $3 and even $1. There is always the concern about fraud, speculation, and even pump and dump tendencies. However, things have improved and so penny stocks are now viewed as a less expensive option for investing in stocks at the markets.

Trading in penny stocks

The essential ingredients when trading penny stocks are volumes and liquidity. These two ingredients make it easy to enter and exit trades. It is also essential that any day trader dealing in penny

stocks have direct access to a brokerage to execute any trades fast and seamlessly. Penny stocks have a tendency of increased volumes then peaking eventually and leaving plenty of traders trapped with expensive shares. Before entering such trades, it is important to perform exhaustive research and make use of all tools and leverage in order to have the best information possible. With penny stocks, the essential point to remember is that price is key so always have an exit plan way before commencing any trade.

Also, part of any day trader's research should include researching and due diligence on the underlying company to confirm its legitimacy. Apparently, penny stocks are highly speculative in nature and are, in fact, the most speculative type of stocks that are publicly traded. Also, plenty of stock promoters engage in fraud by investing in these stocks only to dump them later. This is the reason why most day traders avoid penny stocks and never include them in their trading portfolios.

Therefore, what is crucial at this stage is to ensure that you have a proper trading system in place and that you avoid the stocks that are being promoted through pamphlets and newsletters. Most of such stocks are often manipulated, which is never a good thing for any trader. Therefore, if you are to touch promoted stocks, then make sure that you read any disclaimers and be very aware of the trade you are about to engage in. the disclaimer is likely to reveal the compensation that the promoter will receive for pumping any such penny stock.

Short and long signals

If a day trader intends to deal in long deals, then the only suitable ones are those played on breakouts, reversion signals, and uptrends. The choice of option will largely be determined by the type of trading system adopted. Sufficient care should be taken to ensure that there is no buying into overbought penny stocks. It is pretty challenging to attain short signals when trading penny stocks. It is much easier to find long signals without the capacity to hedge any position. Therefore, trade types get limited. Therefore, any trades entered should have an advantageous price.

When it comes to short signals, then the aim would be to play on downtrends, breakdowns, and reversions. This is for the rare

occasion when short shares are available. Penny stocks rarely see an extended run and the best day is often the fourth day, so this should be taken advantage of. Also, profits should be collected as fast as possible. Liquidity can cause reversals and pullbacks to occur very fast. So exits should be taken very seriously and made a priority.

Placing stop loss

Traders are different from other players in the stock market because day traders are prudent enough to think about placing a stop loss. Other players often never use stop-loss techniques. It is important to remember that penny stocks can breakout and then peak, and once this happens, a serious pullback with a slow recovery will take place. This is always a good indicator that the penny stocks were pushed by stock promoters.

Spreads and volume

One of the most crucial factors when trading penny stocks is volume. Ideally, the stocks you trade in should have volumes of at least 300,000 shares and should generally trade at a price higher than $0.5 per share. When it comes to spreads, then these should be at least 10 – 15%. This range is what should exist between the inside asking price and the bid price.

It can sometimes be quite tempting to trade in stocks worth less than a penny. However, this is just not worth the trouble as such stocks are extremely risky. While penny stocks tend to be liquid, their fundamentals are often rather damaged and very shaky. It is worth noting that penny stocks were at one time regular stocks, but something happened to their fundamentals and the price just nose-dived. Some of the issues that occurred include rejections by the FDA, a downturn in business fortunes, government and regulatory issues, and even bankruptcies. All these are factors that can turn regular stocks into penny stocks.

Trading in penny stocks

Penny stock trading is mostly price-focused combined with technical analysis. The information derived is then used to enter then exit trades. The challenge posed by penny stocks to investors or traders is that they get to hold onto them for longer. Also important are the stocks' fundamentals; therefore, these should be

closely examined before a decision to enter a position is made.

Getting stuck with bad stocks is a very different situation from having a position as a day trader, so detailed research is essential and awareness of the risk that the trade poses. Simply put, a day trader should never be caught up in a situation where you have to invest everything simply because a stop loss was never initiated.

6. Pre-market Trading

Another type of day trading strategy is pre-market trading. Trading in these markets begins as early as 4.00 am EST even though the normal pre-market trading hours start at 8.00 am EST. It is during the normal trading hours that liquidity and high volumes begin to stream in. regular trading starts at 09.30 am EST.

Pre-market trading is generally accessible via dark pools and ECNs. This is very similar to after-hours trading. While there are generally no specialists or market makers in the market at such hours, it is possible that they may be participating in the markets via certain ECNs.

Pre-market trading versus after hours

Generally, the risks of trading the pre-market are much lower compared to the after-hours session. This is because action continues within the markets after 09.30 am EST as compared to after-hours where activity just shuts off. Many traders are likely to be trapped in after-hours trading because it ends at 8.00 pm. Such traders will have no option but to wait until pre-market hours the following morning. Also, trade can resume with a sharp gap against positions taken by the traders.

Pre-market versus normal market hours

There are significant differences between normal trading hours and pre-market trading. The most significant of these are the liquidity levels, which are higher during normal trade times compared to pre-market levels. Other traders are often waiting for regular market times in order to enter into trades, and this has the effect of increasing liquidity. Pre-market can, therefore, is considered as the time where market players are positioning themselves for the new trading day.

The pre-market period also provides the ultimate time to come up with charts and to perform any essential analysis of the market. A lot of the time, the after-hours trading range is significantly different from the trading range witnessed the following day, especially as other traders, investors, etc., come into the market.

The best approach to trade the pre-market is through dark pools and ECNs. It is advisable to trade using limit orders. Direct access via a broker's platform is ideally the best way to process trades and to ensure that there is sufficient liquidity available in the market. Trades in the pre-market can be based on patterns, resistance or support trend lines, and even momentum indicators. This market should ideally be left only for veteran traders with the level of knowledge and experience that is needed. Also, it is advisable to place stop orders at appropriate points throughout the trading process.

Day Trading Styles

Almost all traders share similar goals, which are to make money trading. However, these goals are often achieved via different methods and trading styles. It is possible to modify trading styles so that they can fit the trader's own personal attributes, time limitations, and even profit ambitions. No trading style is superior to others, so finding a trading style that suits a trader's personal preference is absolutely important.

1. Short and Long Trades

There are basically only two different kinds of trades. These are short and long trades. In a long trade, a trader enters a trade by buying into it and then exits a trade by selling at a higher price in order to make a profit. Short trading basically involves what is known as short selling in order to enter a position. Short selling refers to borrowing shares that are not yours with the hope of buying them back later and making a profit in the process. The process of buying back the shares is known as covering. Covering is often done at a lower cost to realize a profit.

Long trades are very common with day traders, other traders, and investors. The idea is always to buy shares or stocks at a low price and then sell the same at a higher price. It is a very straightforward

approach, and almost any trading account can accomplish this feat. However, short selling is not as straightforward as this and often requires what is known as a margin account. Here, shares have to be borrowed to execute a trade and so a broker platform is required.

2. Swing Trading and Day Trading

There are ideally two different kinds of day trading styles. These are based upon the position holding time. Traders should take into consideration the need to manage risk. The term intra-day simply refers to trading within a single 24-hour period. It also refers to a single trading period from the time the markets open until the closing. A day trader can, during the trading period, perform either swings or scalps. However, when a trader enters a position and holds it overnight, then this is aptly referred to as daily swing trading.

Scalping

This is an intra-day trading style. The aim of scalping is to endeavor to accomplish trades throughout the trading period in the shortest time possible. Round trip trades are trades where security, or stock, is purchased then sold at a profit. It also refers to selling short then buying back and making a profit.

Scalping takes advantage of short time frames between one and five minutes. The profits are relatively small, but this is done deliberately. Take the example of a trader who purchases 1000 XYZ shares at $30 each and then sells them shortly at $30.50. He makes about $0.5 * 1000 = $500 in a matter of only a couple of seconds. Had the trader taken a long position, he would have incurred a loss if the share price had dropped at the close of the trading day. Scalping day traders need to be highly disciplined so as to take stop losses and also profits.

Short Term Swing Trading Outlook

Swing traders apply the same principles as day traders. However, the only difference is that they hold onto their positions much longer. Swing traders can be short term or long term. The short term swing traders pay more attention to wider time frames such as 15 to 60 minutes. They also deal with daily charts. Now since their

trading ranges are wider, it is possible for them to adopt smaller positions whenever necessary.

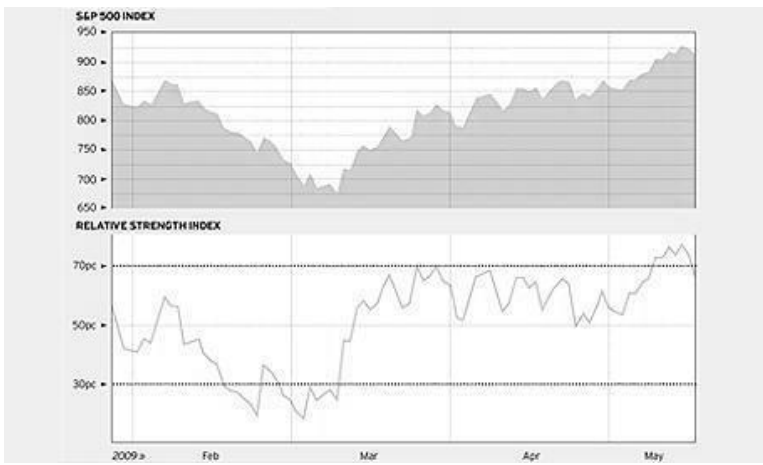
Long Term Swing Trading Outlook

Long term swing trading generally involves larger trading time frames. A trader can, for instance, choose to pick a $30 target price with the daily charts but with only a 300 share long position. This poses a slight risk to the traders, so, in most situation, traders opt for a hybrid approach. This means traders do both scalpings and then proceed into swing trading. This is a preferred approach because the trader is able to offset the risk and can hold to a position for a longer period of time.

Chapter 5:
Portfolio Diversification

Day traders generally execute trades in the course of a single trading day while investors buy and hold stocks for days, weeks, months, and sometimes even a couple of years. In between these two extremes are other forms of trading. These include swing trading and position trading, among others.

Swing trading is where a trader buys an interest in a commodity or stock and holds the position for a couple of days before disposing of it. Position trading, on the other hand, is where a trader buys a stake in a commodity or stock for a number of weeks or even several months. While all these trades carry a certain element of risk, day trading carries the biggest risk.



A trader with the necessary skills and access to all the important resources is bound to succeed and will encounter a steep learning curve. Professional day traders work full time, whether working for themselves or for large institutions. They often set a schedule which they always adhere to. It is never wise to be a part-time day trader, a hobby trader, or a gambler. To succeed, you have to trade on a full-time basis and be as disciplined as possible.

Introduction to Diversification

Diversification is considered an effective risk management technique. It is widely used by both traders and investors. The gist

behind this approach is that investing funds in just single security is extremely risky as the entire trade could potentially go up in smoke or incur significant losses.

An ideal portfolio of securities is expected to fetch a much higher return compared to a no-diversified portfolio. This is true even when compared to the returns of lower risk investments like bonds. Generally, diversification is advisable not only because it yields better returns but also because it offers protection against losses.

Diversification Basics

Traders and investors put their funds in securities at the securities markets. One of the dangers of investing in the markets is that traders are likely to hold onto only one or two stocks at a time. This is risky because if a trade was to fail, then the trader could experience a catastrophe. However, with diversification, the risk is spread out so that regardless of what happens to some stocks, the trader still stands to be profitable.

At the core of diversification is the challenge posed by unsystematic risks. When some stocks or investments perform better than others, these risks are neutralized. Therefore, for a perfectly balanced portfolio, a trader should ensure that they only deal with assets that are non-correlated. This means that the assets respond in opposite ways or differently to market forces.

The ideal portfolio should contain between 25 and 30 different securities. This is the perfect way of ensuring that the risk levels are drastically reduced and the only expected outcomes are profitability.

In summary, diversification is a popular strategy that is used by both traders and investors. It makes use of a wide variety of securities in order to improve yield and mitigate against inherent and potential risks.

It is advisable to invest or trade in a variety of assets and not all from one class. For instance, a properly diversified portfolio should include assets such as currencies, options, stocks, bonds, and so on. This approach will increase the chances of profitability and minimize risks and exposure. Diversification is even better if assets are acquired across geographical regions as well.

Best Diversification Approach

Diversification focuses on asset allocation. It consists of a plan that endeavors to allocate funds or assets appropriately across a variety of investments. When an investor diversifies his or her portfolio, then there is some level of risk that has to be accepted. However, it is also advisable to devise an exit strategy so that the investor is able to let go of the asset and recoup their funds. This becomes necessary when a specific asset class is not yielding any worthwhile returns compared to others.

If an investor is able to create an aptly diversified portfolio, their investment will be adequately covered. An adequately diversified portfolio also allows room for growth. Appropriate asset allocation is highly recommended as it allows investors a chance to leverage risk and manage any possible portfolio volatility because different assets have varying reactions to adverse market conditions.

Investor opinions on diversifications

Different investors have varying opinions regarding the type of investment scenarios they consider being ideal. Numerous investors believe that a properly diversified portfolio will likely bring in a double-digit return despite prevailing market conditions. They also agree that in the worst case situation will be simply a general decrease in the value of the different assets. Yet with all this information out there, very few investors are actually able to achieve portfolio diversification.

So why are investors unable to simply diversify their portfolios appropriately? The answers are varied and diverse. The challenges encountered by investors in diversification include weighting imbalance, hidden correlation, underlying devaluation, and false returns, among others. While these challenges sound rather technical, they can easily be solved. The solution is also rather simple. By hacking these challenges, an investor will then be able to benefit from an aptly diversified platform.

The Process of Asset Class Allocation

There are different ways of allocating investments to assets. According to studies, most investors, including professional investors, portfolio managers, and seasoned traders actually rarely

beat the indexes within their preferred asset class. It is also important to note that there is a visible correlation between the performance of an underlying asset class and the returns that an investor receives. In general, professional investors tend to perform more or less the same as an index within the same class asset.

Investment returns from a diversified portfolio can generally be expected to closely imitate the related asset class. Therefore, asset class choice is considered an extremely crucial aspect of an investment. In fact, it is the single more crucial aspect for the success of a particular asset class. Other factors, such as individual asset selection and market timing, only contribute about 6% of the variance in investment outcomes.

Wide Diversifications between Various Asset Classes

Diversification to numerous investors simply implies spreading their funds through a wide variety of stocks in different sectors such as health care, financial, energy, as well as medium caps, small, and large-cap companies. This is the opinion of your average investor. However, a closer look at this approach reveals that investors are simply putting their money in different sectors of stocks class. These asset classes can very easily fall and rise when the markets do.

A reliably diversified portfolio is one where the investor or even the manager is watchful and alert because of the hidden correlation that exists between different asset classes. This correlation can easily change with time, and there are several reasons for this. One reason is international markets. Many investors often choose to diversify their portfolios with international stocks.

However, there is also a noticeable correlation across the different global financial markets. This correlation is clearly visible not just across European markets but also emerging markets from around the world. There is also a clear correlation between equities and fixed income markets, which are generally the hallmarks of diversification.

This correlation is actually a challenge and is probably a result of the relationship between structured financing and investment banking. Another factor that contributes to this correlation is the rapid growth and popularity of hedge funds. Take the case where a

large international organization such as a hedge fund suffers losses in a particular asset class.

Should this happen, then the firm may have to dispose of some assets across the different asset classes. This will have a multiplier effect as numerous other investments, and other investors will, therefore, be affected even though they had diversified their portfolios appropriately. This is a challenge that affects numerous investors who are probably unaware of its existence. They are also probably unaware of how it should be rectified or avoided.

Realignment of Asset Classes

One of the best approaches to solving the correlation challenge is to focus on class realignment. Basically, asset allocation should not be considered as a static process. Asset class imbalance is a phenomenon that occurs when the securities markets develop, and different asset classes exhibit varied performance.

After a while, investors should assess their investments then diversify out of underperforming assets and instead shift this investment to other asset classes that are performing well and are profitable in the long term. Even then, it is advisable to be vigilant so that no one single asset class is over-weighted as other standard risks are still inherent. Also, a prolonged bullish market can result in overweighting one of the different asset classes which could be ready for a correction. There are a couple of approaches that an investor can focus on, and these are discussed below.

Diversification and the Relative Value

Investors sometimes find asset returns to be misleading, including veteran investors. As such, it is advisable to interpret asset returns in relation to the specific asset class performance. The interpretation should also take into consideration the risks that this asset class is exposed to and even the underlying currency.

When diversifying investments, it is important to think about diversifying into asset classes that come with different risk profiles. These should also be held in a variety of currencies. You should not expect to enjoy the same outcomes when investing in government bonds and technology stocks. However, it is recommended to endeavor to understand how each suits the larger investment

objective.

Using such an approach, it will be possible to benefit more from a small gain from an asset within a market where the currency is increasing in value. This is as compared to a large gain from an asset within a market where the currency is in decline. As such, huge gains can translate into losses when the gains are reverted back to the stronger currency. This is the reason why it is advisable to ensure that proper research and evaluation of different asset classes are conducted.

Currencies should be considered

Currency considerations are crucial when selecting asset classes to diversify in. take the Swiss franc for instance. It is one of the world's most stable currencies and has been that way since the 1940s. Because of this reason, this particular currency can be safely and reliably used to measure the performance of other currencies.

However, private investors sometimes take too long choosing and trading stocks. Such activities are both overwhelming and time-consuming. This is why, in such instances, it is advisable to approach this differently and focus more on the asset class. With this kind of approach, it is possible to be even more profitable. Proper asset allocation is crucial to successful investing. It enables investors to mitigate any investment risks as well as portfolio volatility. The reason is that different asset classes have different reactions to all the different market conditions.

Constructing a well-thought out and aptly diversified portfolio, it is possible to have a stable and profitable portfolio that even outperforms the index of assets. Investors also have the opportunity to leverage against any potential risks because of different reactions by the different market conditions.

An Example

An investor has a total of $100,000 to invest. The best approach is to put the funds in a diversified portfolio, but the challenge is properly or adequately balancing the portfolio. The first step is to check out market conditions and then conduct an assessment of possible returns versus any likely risks. As such, the investor can choose to invest in very secure investments that are likely to

produce long-term income.

Such an investment can include between 10 and 12 stocks that are highly diversified. These are generally stocks from different sectors, industries, and countries. This kind of diversification helps to leverage against any possible risks and also ensures the portfolio is thoroughly mixed.

Portfolio Diversification Approach

Disciplined Investing is a Must

Everyone is in agreement that diversification is basically the right approach. However, as an investor, there is a need to be disciplined even as you invest and diversify your investments. Investing is an art form. Put your money in equities but not all your money. Instead, think of yourself as a mutual fund manager then come up with a list of companies to invest in. You can also invest in funds and trusts like REITs or real estate investment trusts and exchange-traded funds. It is also advisable to go beyond local borders and invest globally. This way, you spread your risk around and stand chances of enjoying much better returns.

Consider Investing in Bonds and Index Funds

Apart from investing in stocks across numerous sectors, a trader may also want to invest your funds in certain fixed-income or index funds. When you invest in securities that closely keep an eye on a major index is highly recommended as you will be able to monitor progress and known when to make adjustments and so on. Such funds charge very low fees, and you will be able to easily track your investments.

Portfolio Building is a Continuous Process

Try to always grow your investments. If you receive some cash from somewhere, you can consider investing part or the entire amount into your investment portfolio. Also, keep adding regular amounts to your portfolio. You can, for instance, add about $500 each month to this portfolio to grow it at a much faster pace.

Learn the Best Exit Times

Sometimes we tend to get comfortable with the purchase-and-hold

approach. This is true, especially when our investments are on autopilot. Yet a smart investor you need to keep looking out for events and special moments. Always remain abreast of events and be ready to act depending on the nature of the event. This way, you will be prepared for the moment when you have to cut your losses and exit your trades.

Watch Out for Commissions

As a trader, you need to remember that there are commissions to be paid as well as fees and charges. These charges can add up over time and become a significant amount. Therefore, keep a lookout for the charges and ensure that they are always maintained at manageable levels. In general, investing should be informative, fun, rewarding, and educational.

However, you need to be disciplined as a trader in order to be profitable in the long term and possibly outperform some of the major indices. Apart from the buy-and-hold strategy, you should diversify your portfolio, keep growing your portfolio, and learn to read the signs and know when the time is right to exit a trade. This way, your trading ventures will become extremely fruitful in the long run.

Diversification Summary

Diversification can easily be summed up using a single phrase. Never put all your eggs in one basket. This is as simple as it gets. However, the statement does not explain exactly how to go about diversification.

The idea behind portfolio diversification is simple. A trader needs to diversify into a whole group of securities, and these should be from different asset classes. It would be wrong for a portfolio to contain only stocks from one company only. Should anything happen to that company, then the investor or even trader stands to suffer huge losses, and such losses can end the investment or trade dreams of a trader.

When an investment is split into two or more different companies and asset classes, then the potential risk facing a certain product is drastically reduced. Apart from investing in more than one company, it is also a great idea to put funds in other securities such

as bonds, futures, and currencies.

Traders need to develop an asset allocation strategy. Such a strategy should mostly focus on investment in stocks and bonds. Asset allocation is closely related to diversification because when done properly, asset allocation leads to a sustainably diversified portfolio.

There are other additions that can secure a portfolio and improve its diversification. These include mutual funds that consist of varied securities. A mutual fund is generally a diversified investment so diversifying into a fund helps in further diversification of a portfolio.

It is advisable to learn how to arrive at a desirable risk to reward ratio. Such a ratio can help determine the best way to diversify funds. A risk-reward ratio provides the opportunity to enjoy a particular rate of return for those willing to assume a small level of risk. Therefore, those willing to take on higher risk levels are more likely to benefit more compared to those assuming lower levels of risk.

There are some who prefer lower risk levels because perhaps of their limited resources or perhaps they prefer minimal complications. Such investors simply mirror a single and balanced fund. Others choose to simply invest in the fund. However, this can be viewed as simplistic by others who may wish for a more diversified approach.

In conclusion, diversification is key for sustainable investment, especially in the long run. It is not just more profitable but provides a risk management element into the entire investment portfolio process. Finding a suitable balance in the choice of assets provides a great approach to apt diversification.

Reducing Day Trading Risks

Risk Management

With any trade, risk management is an essential component despite the fact that it is often overlooked. It is crucial that day; traders learn about risk management if they are to successfully trade and remain profitable in the long term. The good news is that there are some simple strategies that can be adopted to ensure that trades are

protected and risks management appropriately.

Basically, risk management is one of the most important aspects of the life of any serious day trader. The reason is that a trader can actually see 90% of their trades make money, but the 10% losing money may result in a net loss if there is no proper risk management. Therefore, it is important to plan all trades carefully and to take measures to protect all trades against any losses.

Trades should be Planned Appropriately

It is a well-known fact that a good strategy will win the war rather than the battle. A good day trader needs to plan and come up with a winning strategy as the first step. A lot of traders often live by the mantra, “Plan the trade and trade the plan.” This is also very similar to war planning because those who plan properly are likely to win.

Take Profit and Stop Loss Points

Traders need to come up with two very important points. These points represent two major keys that enable traders to plan ahead or in advance. A good day trader ideally knows their entry point as well as their exit points. These important points will guide the trades and will indicate at what point the trader should buy stocks and at what point the stocks should be sold off.

When a trader determines the price they wish to pay for a stock and the price they wish to sell, then it is possible to find out the likelihood of the stock performing as desired. If this can be measured and confirmed, then the trader should enter and execute the trade.

Also, traders who enter a trade without making these kinds of determinations are likely to suffer loss and will in effect cease trading and instead gamble with his resources. Whenever traders start to make losses, they believe that they can always recover their money if they invest more. This is often a lack of discipline, and the trader is likely to lose even more money.

A stop-loss is defined as the actual price where a trader will choose to sell a stock and incur a loss on the particular trade. This is a situation that happens when trades do not proceed according to the

trader's plans. These points are ideally designed in order to limit losses before they get out of hand. It is always tempting for a trader who is losing money to hang in there in the hope that the losing trend will end and profitability will resume once again.

Converse to this is the take-profit point. It is important to set the take-profit, which is really the price at which a trader exits a trade by selling the security and then takes a profit from the sale. The take point is often the point at which any additional upside will become limited beyond this point. Let us assume the trade approaches a key resistance level after a large upward movement then traders can choose to exit the trade at this point.

Improving the Risk Management Process

1. Setting the Risk: Reward Ratio

When an entry signal is sighted, work out the most appropriate place to locate the stop loss than first take the profit order. As soon as a suitable price level for the orders is noted, the next step is to determine the risk versus reward ratio. Now should the outcome not be satisfactory, then it is advisable to quit the trade. Traders should generally not attempt to reduce the stop loss or widen the profit order. Discipline, at this point, is very important.

Rewards in trade are never certain and are the only potential. It is the risk that traders have control over so it should be seriously considered. A lot of the time, inexperienced traders will take the opposite approach and later suffer the consequences.

2. Traders should Avoid Break-even Stops

Creating a no-risk trade by locating the stop loss close to the entry point is something that should be avoided at all costs. The reason is that this is a dangerous move and most often not profitable. While seeking some protection is advisable, these kinds of moves cause more harm than good and should always be avoided.

3. Fixed Stop Distances should not be used

Sometimes a trader may wish to make use of a fixed number of points on the stop loss then place profit orders on markets and varied instruments. These are essentially shortcuts and should not be used under any circumstances. The reason is that they often

neglect price movements and the general operation of the markets.

Also, things such as momentum and volatility are never static but always changing depending on various factors. These will also have an effect on the price movement and will affect fluctuations over time. When volatility is high, profit order points and stop loss points need to be wider to maximize profits during price swings and to prevent any premature stop runs.

4. Risk-Reward and Win-Rate Ratios should be compared together

There are traders who do not believe in the win-rate ratio and consider it irrelevant. This is actually not a wise thought because it is a very important metric. Win-rate on its own is not a very useful metric, but when pitted against the risk vs. reward ratio, then it provides important insights.

Traders should Work Out their expected Returns

Traders need to be able to work out any expected returns from their trades. Now both take-profit and stop-loss points are essential to work out this figure. Expected returns provide an important figure that cannot be underestimated. This figure that results from the calculations causes a trader to think and rationalize their trades. It also ensures that only the most profitable trades are chosen.

How to Set the Stop-Loss Points

It is the technical analysis that mostly helps to determine the take-profit and stop-loss points. However, fundamental analysis of the stocks in question does play a crucial role, especially with the timing. For instance, if a trader is holding stock and the earnings report is around the corner, then such a trader will have to dispose of those shares before the news affects the markets. This is necessary regardless of whether the stock has hit the profit margin or not.

One of the most popular ways of setting up these points is to use the well-known Moving Average. Moving averages are pretty simple to work out and are tracked closely by market players. Some of the important Moving Averages include the 9, 20, 50, 100, and 200-day averages. These should typically be applied to any stock in question

and then making a determination as to whether they have had an effect on its price or not.

Also, the support and resistance trend lines can be used to place the take-profit and stop-loss levels. First, the trader needs to draw these lines simply by connecting all the past lows or highs that appeared on the above average and significant volumes. The main aim here is to effectively determine the levels where the stock price is affected by the trend lines when volumes are significantly high.

Traders need to be able to determine at what points they enter and exit any traders that they wish to participate in. This determination needs to be made before the trade is actually entered. When indicators such as the stop-loss are effectively used, then the trader will be able to minimize their losses and also reduce the frequency with which trades are excited unnecessarily. The bottom line here is to prepare early, well ahead of time so as to be sure of success in all trades.

Chapter 6:
Life of a Day Trader

A lot of retail traders operate from a small home office. Others work in regular offices but remain small traders with limited funds but sufficient trading equipment. As a day trader, there is basically no boss or supervisor to tell a trader what to do. Nobody watches over them or bosses them around. This means a trader has the freedom to organize and manage their trading days.



Because of this freedom, day traders need to exercise a lot of discipline. Traders need to wake up early and prepare for the trading day. Mental preparation is part of a trader's morning ritual before, during, or after breakfast. It is advisable to be up a couple of hours before the trading day begins and ensure everything is in place. There are a couple of things that generally need to be achieved.

1. As soon as breakfast is made, the trader should rehearse their strategies in their minds and probably on paper too. Sometimes it is necessary to run a strategy on a demo platform. Also, a good plan should be made and followed to the letter. This plan includes how much money to place on a trade, which points to exit a trade, when to take profits, and so on.

2. Traders need to check and confirm their trading accounts and the amounts therein. It is crucial that a trader knows the amount available for trading purposes so they know the amounts they can spend per trade. It is recommended that traders should not spend

more than 2% of their trading capital on a single trade. The accepted range is between 1% and 2% of the account balance. Beginners with no prior trading experience should not spend more than 1% of their trading balance per trade. Also, a trader should exit their positions three minutes prior to a major financial or economic announcement.

3. It is advisable to always or regularly check the financial calendar and note any major events. Any such events should be clearly marked onto the calendar and reminds initiated. These events have major implications for stocks and activity at the markets.

It is crucial that day traders learn how to select the best stocks to trade. This is because the stocks chosen for day trading will pretty much determine the outcome of your trading ventures. As such, choosing the correct stocks ensures that you fare better at the markets and maximize on profitability.

Identifying Stocks for Day Trading

1. Funds Available

The first instance is to take cognizance of a trader's financial position. Depending on the number of funds available, you can determine the stocks to choose. There is a wide variety of stocks to choose from. However, you can only choose as much as your funds allow you.

You also need to consider the amount of risk you can tolerate. Generally, the amount of risk a trader is willing to take the more they stand to win. Traders also need to consider buying a security in a field or industry that they are familiar with. For instance, an accountant may be happy trading financial stocks while an engineer will be at home with tech stocks, and so on. Such considerations will ensure you understand what is going on in the industry, and this will boost trading ventures.

Liquidity

Traders also need to find securities that are highly liquid and trade in large volumes. There is a reason for this. When a security is trading in high volumes, then it is easy to enter and exit positions. Also, highly liquid securities make it easy to get paid upon exiting a

position. Some of the best financial securities that have large volumes and are liquid are blue-chip stocks. These are stocks of highly valued companies that are constantly making large profits, are stable, and considered very valuable.

Stocks that are highly liquid tend to be more easily traded and are easier to discount compared to many others. Also, stocks and securities from firms with large volumes of shares traded tend to be more favorable. Traders should take the time to conduct analysis in order to find which stocks are most suitable. A good stock is one from a large-cap company rather than a low cap firm. This is because it is easier to find buyers of large volume stocks compared with buyers for low volume stocks.

Volatility

Some of the best instruments are highly volatile ones. Volatile stocks and securities provide day traders a chance to capitalize on the rapid and numerous price changes. Remember that day; traders make most of their money due to the rapid or frequent price changes. As such, stocks that are constantly moving up and down or are volatile are much better and preferable compared to less volatile ones.

We have what is known as the TVI or trade volume index. This is a measure of the volumes of a particular stock that is trading at the market. Using this index, traders can determine whether or not to choose the particular stock. TVI indicates the total amount of cash that is following into and out of stock. The volume gives a clear indication of the stock's activity at the markets.

Industry

Another crucial aspect to consider when selecting a stock is the industry. One of the best industries for day traders should be the financial services sector. This sector is excellent because it features most of the above factors like large volumes and volatility. A great example, in this case, is Microsoft Corp. This is a well-established company with a large global market, growing income, and a positive reputation.

Microsoft Corp also happens to be among the most highly traded stocks. This is why it is among the most preferred stock by most day

traders. It is definitely an excellent choice for day trading forays as it exhibits all the desired characteristics. Bank of America is a large corporation, it trades a large volume of shares each day, its stock is volatile, yet the bank remains stable and profitable through the years.

Emotions

One important point worth mentioning is that a day trader should never let emotions take charge of trading activities. When a trading strategy is formulated, it should be implemented to the letter. All too often, traders either become greedy or despair and then begin trading guided by their emotions.

For instance, they refuse to exit a winning trade instead of collecting profits first. In other cases, traders choose to continue incurring losses beyond the stop-loss point. These are dangerous attributes and are common among new and novice traders. It is a practice that should be shunned at all costs for successful and profitable day trading.

Summary

Day traders execute various intraday strategies in order to benefit from the volatility at the markets. To be effective, the first step should be the identification of suitable stocks to trade.

There are different stocks available in the market. A good trader will conduct an analysis using tools and charts to find the most appropriate stocks. These are stocks with high volumes from stable companies that showcase a fair amount of volatility.

It does not have to stock only. Day traders can also deal with other commodities such as bonds, currencies, futures, and options. Once the trading instrument has been determined, the only other step is to develop a strategy and begin implementing it. A major challenge that numerous traders experience, especially novice and beginners, is that they let their emotions interfere with their trading. This means that traders take their time to conduct research and come up with a trading strategy only to discard it at the last moment.

Emotional stability is crucial because it is the only way for a trader to successfully execute a strategy and make profits along the way.

When emotions take charge, a trader will keep holding on to a falling position beyond the stop-loss point. They will lose money using this approach. However, when winning, they do not take profits as was intended, but instead, they tend to keep at trade and risk losing all their winnings.

Life of a Typical Day Trader

It is commonly believed that the life of a trader is fun and exciting and that they deal in numbers and money all day long. This is far from the truth. A trader's life is not all fun and glam, and they do not really live on the edge. While it is true that they spend the entire trading day dealing in options, stocks, currencies, and other securities, they really do work very hard and tend to focus too much on the markets.

The life of a day trader can actually be exciting simply because of all the numerous events and unexpected occurrences that can take place. But in general, most trading days are quiet with little or no excitement but general trading as usual. There is hardly any action except for reading charts, entering positions, checking news feeds, and so on. Therefore, any glamor that people think exists in day trading is only a figment of the imagination.

You will also find that most day traders, especially small retail traders, trading from their home offices. Many have established a workstation at their home offices from where they do all the work. We also have institutional traders working from fully furnished offices with access to plenty of resources. At any one time, this day, traders will be entering positions in the market and make trades worth hundreds of millions of dollars.

Traders and their Trading Styles

There are different definitions that define traders. For instance, experts sometimes divide traders by the time in which they enter and exit trades. This time is also known as the holding time. At other times, traders can be classified based on the ways in which they identify opportunities and the approach they use to trade these opportunities.

For instance, we have discretionary traders. These are traders who base their trades on decisions based on certain factors. We also have

system traders who are named thus because they automate their trades and use the system to execute their strategies. Other kinds of traders are the day trader, swing trader, scalpers, and high-frequency traders. Based on these definitions, it is clear to observe that there is no typical day trader but a variety of different strategies adopted by different day traders.

How to Take Profits

The whole purpose of trading is to generate profits. So every time a trader trades and the trades earn a profit, these profits need to be consolidated, locked in, and then taken out. If this does not happen, then the profits could disappear and sometimes even turn into a loss.

A good day trader should close all their open trades just before the markets close for the day. One of the best ways of collecting any profits generated is to exit at the close of one trade. There are other ways of taking profits. Learning to do so is essential if you want to be profitable.

1. Take Profits when Price is Close to Strong Resistance or Support

It is advisable to move in and take profits at one of the established points where the price is likely to reverse. If you have a chart, then you can search for points where the stock makes attempts to drop after an upward trend. For instance, fins a suitable support area.

If the trade entered is a short position, then it is advisable to exit just above this support area. Now if the price continues falling, this is not desirable but is something that could happen. A fall in price will break the support, and the trader will have to enter another short trade.

A trend analysis is essential to arrive at the best position to take in profits. If there is a strong upward trend, then resistance is very likely to be overcome compared to other situations such as the range. The trick here is to simply wait and see if the price can overcome the resistance. If it does, then a trader should exit any long positions immediately.

However, should there be a significant downward trend, then the

support is highly likely to stay put and not get broken. The trick, in this case, will be to wait and see if the support will sustain the momentum so that more profits can be extracted. Any short trade should be exited should the stock price continue going higher beyond the support area.

The Price can Stall and Reverse

It is possible in some cases for the price to stall and sometimes even make a reversal. It is advisable to study tendencies in order to determine the best exit points. Sometimes it may be profitable to avoid exiting at the resistance and support points. However, in all cases, it is important to always have a determined exit point. If a price continues to increase, then keep watching until it stalls then exit at this point.

In stocks trading a consolidation is also known as a stall. It refers to a collection of three or four price bars which do not progress any trend that existed. When the price momentum stalls, it will indicate on the charts. A trader should locate their exit point just beneath the upper side of the stalled bars. If this is not possible, then an alternative is to exit a trade as soon as the price falls below any one of the three bars.

Basically, consolidation or stall does not necessarily imply that there will be a price reversal. This may not necessarily be the case. However, it presents an excellent opportunity to take profits.

If a trader is convinced that the upward trend will proceed for a while, then it is advisable to hold on and the only exit once the share price starts to trend downwards and moves below the consolidation point. This is an excellent approach to protecting profits, and it can get better by searching for other exit points further up.

Take out Profits before Major Financial Announcements

All traders are aware of the impact of major economic and financial news on the markets. Depending on the news, stock prices are likely to dip or rise. Such news causes the stock market to be very volatile. Any day trader knows that they should take profits right before any major announcements in the business and finance worlds.

The reason for this is to consolidate any gains and exit the markets profitably. Day traders often focus on capturing the market in its normal conditions throughout any trading day. However, all this could change with a major announcement.

Announcements such as economic release news, payrolls, company losses, and so on can result in huge price moves due to volatility. Taking profits before any such major announcements are generally the norm.

Traders will avoid unnecessary turmoil or risks associated with major announcements. Once a trader exits the markets after the major announcement, the next step would be to review the market and then see how they can capitalize on the resulting movement.

Taking Profits

Traders need to be very attentive to the markets and to actions that may affect the market. Profits are often taken at resistance or support points, and attention is also necessary for such instances. Exiting generally occurs when the momentum slows down or when the trend reverses. There is always the possibility of entering into other trades, but the profit opportunities may not be similar.

Regular and close monitoring of economic news is a must. A good day trader should keep one eye on the news and another on the trading platform. Monitoring economic and business news then exiting a position before the news is released is absolutely essential.

Such events, when announced, can have a huge impact on the markets and taking profits early enough is definitely the best approach. Once the news is released, the trader is free to get back into the market and see what opportunities are present. Also, it is important to know that the scenarios mentioned above do not happen all the time.

Not all day trading sessions will see a relevant support and resistance position or a consolidation point. Therefore, it is advisable to be on the lookout, be disciplined, and learn the best time to take profits and generally have a suitable profit taking plan.

A Typical Trading Day

Pre-Market Hours

The markets usually open at around 9.30 am eastern time. However, traders are often up and about way before the opening of the markets. They usually grab a mug of coffee and catch up with the news. Finding out the latest in the worlds of finance, business, and economics or even politics is crucial. Some of the more reliable sources of this information include Bloomberg, Yahoo Finance, Google Finance, and CNBC.

The best time to get seated on the trading desk is at least 10 minutes before trading starts. This is for stock traders, but others may require more time. The first few hours when trading begins always has some volatility, which is desirable.

Preparations

It is advisable to prepare appropriately for the trading day. There are different ways that this can be done. One of these is practicing a strategy. It is important that a strategy is tested sufficiently and then planned to ensure that it works perfectly.

A Trader's Life

As a trader, you will need to be a lot more speculative compared to the average investor, which leads us to the use of fundamental and technical analysis. Technical analysis will come in handy when you plan your trades. You will also require additional tools, including price charts, which are crucial tools for any active trader.

You will need to make a lot of trades if you are to be profitable. High trade volumes are recommended with volatility. As a trader, you should find volatile stocks with large volumes and plenty of price movement. The reason why you should deal in high volume stocks is that price movements are often small, so to maximize profits, large volumes are necessary.

Another important aspect of active trading includes the regular application of limit orders. These orders enable you the trader to determine and set stock prices ideal for selling your stocks. As a trader, you need to plan your trades so that you know when to take profits and what points to exit a trade. To exit a non-performing trade, you will need to define stop-loss points.

Sometimes traders, especially inexperienced and novice traders, let

emotions get the better of their trades. In some instances, they are scared of losing money, and so they exit trades at the slightest price pullback. Others allow the price to fall astronomically thinking they will recoup their money later. They end up losing large amounts of their trading capital. This is the wrong approach that should be avoided at all costs.

Your trades should be based on your analysis and not emotions. You need to sit down and take time to plan and work out your trades. Use all the tools at your disposal to chart your pathway. Along the path, you will need to identify a take-profit point as well as a stop-loss point. If you do your analysis properly and learn how to execute trades the correct way, then you will not need to let emotions take charge. Instead, you will allow your trades to execute per the plan to conclusion. This is a more stable, more profitable, and the only recommended approach to active trading.

This way, you will be able to trade without having to watch your trades closely. In rare cases, you may want to intervene. For instance, if you collect the profits and the market continues on a bull run, you do not need to exit right away. You can first collect profit and let your trade continue on with the winning trend. However, you should work out and define new take-profit and exit points. These will ensure that your trades remain profitable until the trend changes direction.

Actual Day Trading

It is highly advisable to trade futures, stocks, or currencies in the first hour of trading as soon as the markets open. Markets open at 09.30 a.m. EST every Monday to Friday. There are securities that are best traded in the pre-market. These are ETFs and actively traded stocks which are best traded between 8.30 a.m. and 9.30 a.m. On the other hand, Forex is traded at a much earlier time, probably from 6.00 a.m. because it is an international market that is always available.

Trade activity can go on until around 11.30 a.m. EST because, at this time, volatility tends to go down as the markets begin the lunch break. There are novice traders who mistakenly believe that less is more. As such, they tend to keep at it even when volatility is very low, yet the saying less is more aptly applies in this case. There is

basically not much activity at the markets during the long lunch hour, and a break would do traders a lot more good than trading in less than ideal conditions.

Ideal Trading Hours

Ideally, it is best not to engage in any trade during the lunch hour. The break is important because trading can be a very intense affair. The profits at this time are minimal, yet traders spend large amounts of money as well as emotions in each trade. It is advisable to wait until 2.00 to resume trading. The time between 2.00 p.m. and 4.00 p.m. is also great for traders.

In fact, experienced traders claim that the last hours of trading are among the best because volatility is extremely high. In fact, the final hour of trading is the second most volatile hour after the first initial hours. Traders, however, need to remain sober and calm. Day trading is an exciting undertaking, but it does not call for hyper-excitement. A trader who is always super excited at the prospect of trading implies something seriously wrong. Probably such a trader has not mastered the basics and is not properly prepared for the trading floor.

Day traders generally need to always be up to date with the latest news and current happenings in the worlds of business, finance, and sometimes even politics. Information sources include print and electronic media as well as online sources such as mobile and internet. Other items of news that could be of interest include earnings reports, the federal government's interest rates announcements, and the general performance of the economy.

Day traders deal in a variety of securities including bonds, currencies, futures, and options. Once the trading instrument has been determined, the only other step is to develop a strategy and begin implementing it. A major challenge that numerous traders experience, especially novice and beginners, is that they let their emotions interfere with their trading. This means that traders take their time to conduct research and come up with a trading strategy only to discard it at the last moment.

Review your Day

At the end of each trading, a trader needs to take some time out and

review the entire day. This occurs at different times for different traders. For some traders, it could be as early as 10.30 a.m. while for others it could be at 4.00 p.m. EST. The time will solely depend on the style and strategy of a trader.

At the end of it all, a trader should take a screen grab of their computer. The screen grab is then printed so as to observe it keenly and learn how the day went and if anything went wrong. When the image is ready, important points should be clearly marked. These include the trade levels as well as the profit made or loss incurred.

Also important on the day's chart are the hours traded, the total number of trades entered, number of winning trades, and the total amount earned during the entire trading day. Also, any losing trades should be noted down as well as the total loss incurred. The net profit should also be noted.

Going over the trading day is extremely important. By reading and examining the chart, a trader is able to walk back through the trading day and note the things that went wrong and all the things that went according to plan. Remember that traders always trade with a plan. When the plan is implemented to the letter, then the trader is likely to succeed.

Different screenshots are taken and marked accordingly, then saved. They are saved using the date, month, and year. All these different charts should be stored in one common folder. This will make it easier to search and find the trading events of a specific day.

The best way of reviewing these trades is to do so on the weekend when there is no active trading. It is very important that these trades are reviewed so that traders note and observe what is working and areas that need improvement. Once the important points are noted, that is the things that went wrong and those that worked out right; the next step is to practice these for a period of time on a demo platform until there is a considerable improvement.

This practice should be undertaken at the end of every trading week. It helps traders note what's working and capitalize on it while improving on things that are not working. This way, the trader is able to avoid losses and improve on profitability.

Tips for Successful Day Trading

It is advisable to always find reports from analysts and read them. Analysts always focus on various aspects of the economy, such as macro and microeconomic factors, industry-specific issues, and down to specific shares. Their reports are crucial for successful trading.

Once the reports are read and internalized, traders should head to their computers and get their trading and analysis platforms ready. There is basically a lot of technology at work include the exchanges, the broker, trading platform, the internet, and so much more. Traders should ensure that all these different though united systems are in good order and working as required.

As soon as the trading session gets underway, the trader should enter the market and begin scanning stocks. The average retail trader will access perhaps one or two markets unless they have at least one year's experience of active trading. Different traders may have different parameters they are interested in when scanning stocks. Some may be looking for stocks that meet certain parameters, while others may have different goals.

Good trading strategies are likely to win in the end even though outcomes are unknown when a stock or other security is selected. This element of the unknown makes trading fun and exciting, but it should not introduce worry, stress, or anxiety.

While early trading is advisable, the first 30 minutes are considered to be the most volatile. As such, some traders opt out of the initial half hour. This helps protect them from being eliminated from a position. From this moment on, it becomes a waiting game as traders search and wait for trading opportunities. Since a plan and strategy are ready, traders will hope for an opportunity in line with their analysis.

Orders are ordinarily submitted via an order entry interface that connects directly to the markets. This is how traders are able to enter multiple orders all at the same time. Some traders enter one position and exit before entering another, while others enter multiple positions all at the same time. The choice will depend on the chosen strategy.

Sometimes traders will wait for late morning trend reversal chances.

Basically, as of noon approaches, traders will hope that most positions will attain profitability prior to lunch time. Beyond the lunch, the markets may remain uneventful until much later.

To close out markets, a trader will wind down their activities and review any trades that are still open. The trader will also enter a log of activities into a log book for later reference. When this happens, the trader is likely to generate a procedure which, if consistently used, can help the trader improve their trading and be more profitable.

The main task of a prepared day trader is simply to identify trade setups and execute them as per the trading plan while managing these positions correctly. Managing in this instance refers to observing a trade regularly and making the necessary adjustments depending on the performance of the trade. A trade that is making money is allowed to run for a while and profits collected periodically. A trade that is losing money is exited and so on. If this kind of focus is maintained, then there will be no reason to worry or experience anxiety. An organized trader should be able to get the job done in the few trading hours when volatility is high enough.

Mindset and Emotions of a Day Trader

Day trading can be extremely profitable and has a number of advantages. Traders become their own bosses. While day trading is sometimes boring, most day traders claim to love the job and enjoy every minute of it.

The most crucial aspect is to understand strategies extremely well, such that nothing causes worries or excitement. Also, day trading is really hard work. Putting in 40 hours each week can be exhausting. Even then, achieving maximum profitability is possible. There are traders who do this while others spend an entire week trading but end up receiving no paycheck.

Days should be spent monitoring open positions and scanning for stocks while evenings are spent fine-tuning strategies and improving trading plans. Most day traders tend to join trading chat rooms to chat, share ideas, and learn from other traders.

A day trader needs to ensure that they are completely knowledgeable when it comes to trading strategies, systems, and setups. A lot of practice is necessary before acquiring the necessary skills needed to trade successfully and become profitable.

A trader who understands the trading process does not need to worry about the outcomes at the market. All they need to do is have a plan, strategy, and necessary knowledge of entering and exiting positions. Risk management skills are also necessary. This way, a trader will not need to worry about what happens on the trading floor. Some trades will be successful, and others will not. This is typical and happens even to the best of traders. No one wins 100% of their trades.

Therefore, following a plan rather than trading with emotions should be the norm. It is understandable to feel disappointed when a trade fails, and money gets lost. However, sticking to plan is important. Letting emotions take control of the trading process is completely wrong and is a recipe for disaster.

Conclusion

Thank for making it through to the end of this book, let's hope it was informative and able to provide you with all of the tools you need to achieve your goals whatever they may be.

The next step is to learn a few strategies and master them as well as you can. The strategies that you are most comfortable with should then be practiced on a demo account. Most brokers offer demo accounts so find a broker and begin practicing. You should practice as often as possible in order to perfect the strategy. Once you feel confident enough, you can then begin trading at the markets using your own funds. You should then start earning lots of money within a relatively short period of time.

OPTIONS TRADING

Complete Guide for Beginners. The Fundamental and Powerful Strategies that you Need to Know to Start Making Money and Become a Successful Investor

Introduction

Congratulations on downloading this book and thank you for doing so.

The following chapters will discuss the basics of options trading. This is an introductory book that introduces you to options so you understand how they work and how to trade in them.

Options provide an alternative to stock and currency trading. You will learn all about options being a form of derivative. People often think that options are complex and not easy to learn. This is far from the truth as options can easily be understood.

You will learn about different kinds of options, a variety of trading strategies, tips on placing successful trades and so on.

There are plenty of books on this subject on the market, thanks again for choosing this one! Every effort was made to ensure it is full of as much useful information as possible, please enjoy!

Chapter 1:
An Introduction to Options Trading

Trading stocks is a simple process. All you need to do as a trader is place an order with your broker to buy or sell certain securities and the order will be executed. Options trading is not as simple as this but it can be understood. It is an extremely profitable type of securities trading hence the reason why traders need to learn about it. Options may seem overwhelming at first but with time, the concept can be understood.

What are Options?

We can define an option as simply a contract entered into by a buyer and seller. The contract involves an asset which is usually a security. In most instances, we have stocks but we also have indexes, currencies, and futures, among others.



The options contract awards a buyer the right to purchase or sell the asset, often referred to as an underlying security, at a certain price and within a set period of time.

Derivatives

Options are classified as derivatives. Derivatives are products whose value is derived from an underlying asset. Options are contracts whose terms are based on underlying securities. The value of an option contract is derived or associated with a particular security.

Complex

Trading options is considered by some to be a complex subject. However, it is only complex when it is compared to simpler investments such as sale and purchase of stocks or trade in basic stocks and so on. Most traders get to understand this subject once they have a clearer picture of how options work.

Trading options is a strategy that is occasionally used by experienced traders to leverage securities and mitigate against certain risks inherent in the markets. If a trader holds certain stocks but expects the price to fall because of certain reasons, then the trader could use options to mitigate against the risks of loss.

Ordinarily, investors often buy low then sell high to be profitable. However, this is not always the case with options. When it comes to options trading, a trader can make money when the prices are low, when they are high, and even when the market moves sideways only.

Options trading can be extremely useful to investors in different ways. Traders can use options in order to protect their investments from losses. They can also trade directly in options and make huge and astronomical profits. However, options trading is an extremely risky affair. Chances of traders losing their money are high. Even the best of traders do lose some of their trades. The risk is considered serious because traders stand to lose not just the entire investment but losses can sometimes be unlimited. This means traders can be liable for losses larger than what they bargained for. That is why it is advisable to trade cautiously and only engage in trades that are simple and less complicated. In general, the more complicated a strategy is, the riskier it is. There are other factors associated with options trade. These include time decay and implied volatility.

Options trading process is a bit more complicated compared to selling and buying of stocks. Sometimes buying or selling options is a huge gamble. It is also much more difficult to gain approval as an options trader compared to a regular trader. Also, it is highly advisable to consider the consequences and effects of trading options especially with variables such as time decay and implied volatility.

However, much as options trading process is thought to be complex and highly risky, the fundamentals are relatively easy to follow and comprehend. And that is where it all begins. A good trader needs to develop a strong foundation and clear understanding of a concept and then building up from there. As soon as you are able to understand the basics of options trading, you will then be in a position to understand more complex features and details pertaining to options.

Characteristics of Options Contracts

Options are generally a lot different compared to most other financial securities like stocks, commodities, bonds, and currencies. The value of an options contract depends upon the value of the underlying asset. As such, options are ideally contracts permitting future transactions based on the underlying security. The contract is entered by two parties consisting of a buyer and a seller.

The contracts come with terms relevant to the future transaction. For instance, there is always a definition of the underlying asset and its properties. For instance, the contract will define the underlying security, the price, expiration date, and if it can be sold or purchased.

Details of Options Trading

There are numerous ways to trade securities at the markets. Traders and investors have a wide choice of securities to choose from. The characteristics of options are rather unique and different from all other instruments. While it is more complex and complicated than all the others, its most basic tenets are very similar to that of other securities.

The basics here are as simple as buying and selling securities. Traders deal in options in order to make profits. The crucial point to note in this instance is that when it is profitable, it is extremely profitable. Traders occasionally make profits of 300% and even higher when they get things right. This is very possible as options are potentially highly profitable. Even the complex options are contracts are similarly designed to generate profits for the trader.

Options offer numerous ways of making profits. Traders can profit from the price movements of various items such as currencies,

stocks, indexes, and even bonds. There are opportunities to make money when prices go up, when prices fall, and even when prices make sideways movements only. However, they are not always straightforward which means traders have to be extremely keen and sharp at all times.

Reasons Why you Should Trade Options

Traders may wonder why the need to diversify into options when other securities are doing just fine. The important point that needs to be understood is that options can be extremely profitable in certain instances and offer different ways of profiting. Basically, a trader can make money in any market condition. This means money can be made when the markets are bullish, bearish, or experience no movement at all.

Experts agree that trading options offers plenty of benefits that are not offered by other types of securities. While not all traders may want to engage in options trading, there are certain aspects of it that other traders find attractive.

1. Potential for Astronomical Profits

One of the main reasons for trading options is the opportunity of making significantly large profits compared to all other forms of trade in the markets. This is possible even without large sums of money. The principle behind this approach is leverage. A trader needs not have large amounts of funds to earn huge profits. For instance, with as little as $10,000, it is possible to earn amounts such as $300,000 or even $800,000 simply by using leverage.

Take the example of a trader whose trading fund is $10,000. The trader wishes to invest this amount in Company ABC. Now the current stock price is $20 though this price is expected to rise. The trader could use the funds to directly purchase the shares and receive a total of 500 shares for his money. If the stock price was to rise to $25 within a month, the trader will have a made $5 per share or a total of $2,500 in profits.

Alternatively, the trader could purchase call options of XYZ stocks with the same amount of money. The options allow the trader to purchase back the underlying stocks within a certain period of time. Now, options contracts cost between $1 and $4 depending on

certain factors such as the value of the underlying security. In our example, one call options costs $2 so for the $10,000, the trader receives 5,000 options contracts.

If the trader chooses to exercise the right to sell the underlying shares in the next one month, then he stands to make a profit of $5 per share. Remember that he has a right to a total of 5,000 shares for a total profit of $25,000. This clearly demonstrates the capacity and power of options as well as how profitable this kind of trade can be.

2. Great Risk vs. Reward Consideration

Like all good traders, it is essential to weight the risk posed by a certain trade compared to the possible rewards. When trading using options, then the style adapted will indicate the type of risk inherent in the trade. The above example clearly shows how profitable options trading process is. If a loss was to be incurred in the above instance, then the total loss would have been the cost of the options.

In this instance, the risk is well worth the reward because the amount set to be lost is insignificant compared to the amount of profit to be made. In general, the higher the risk then the higher the potential return. Any time that a trader considers a trade, then the risk versus reward ratio should be taken into consideration.

As an options trader, you should learn how to benefit from volatility. Volatility needs to be your friend and partner as you can benefit from sharp and sudden movements at the markets. Options are mostly affected by implied volatility which is essentially the most crucial factor affecting options prices. You need to learn to be on the lookout for implied volatility and determine whether it is low or high. This way, you will easily be able to get a sense of direction regarding the type of options to engage with.

3. Versatility and Flexibility

Another extremely appealing benefit of trading in options is the inherent flexibility. Options offer lots of flexibility with dozens of different strategies to pursue. This compares really well with numerous other trade and investment options out there. Most of these do not offer as much flexibility as options do. Also, most other

securities have limited strategies and this tends to limit the flexibility that a trader has on that security.

Take stocks for instance. Even stock traders encounter certain limitations which are not inherent in options trading. There are plenty of strategies ranging to simple to compound to complex strategies. Stock traders generally buy, hold, or sell stocks. There isn't much else that they can do. This contrasts greatly with options because of the tens of strategies available to them. The versatility and flexibility inherent in options trading far surpasses that of most other securities.

Firstly, options' flexibility allows them to be traded based on a wide variety of underlying securities. The variety and range of options strategies is massive. Also, the spreads provide real flexibility in the manner in which they can be traded. Traders have flexibility and versatility when it comes to limiting risks of assuming market positions, when it comes to hedging, and even simply trying to benefit from stock movements, there are numerous opportunities available.

Cons of Trading Options

While options have certain amazing benefits including flexibility, they do carry some disadvantages. It is crucial that traders understand the risks and cons associated with trading options. The numerous benefits have seen more and more traders, including amateurs and pros, venture into the world of options in the hope of cashing in on this lucrative trade.

Not an Easy Task

First of all, it is advisable to note that trading options is not as simple as it sounds. Options are complex securities. They are actually contracts that come with certain terms. These terms need to be clearly understood and taken into consideration at all times. Part of the options contracts has to do with time. Unlike stocks and other securities, options have a time limit. This time decay factor makes them extremely short-lived. If a trade strategy does not work out, then the options could expire worthless.

One of the most prohibitive factors about trading options is its complex nature. Numerous numbers of traders avoid options

because they are difficult to master. The basics are quite okay and relatively simple to comprehend. However, they have a limited scope as well as limited profitability. Real profitability lies in the compounded strategies which can be quite complex.

Traders can lose a lot of funds if they do not master options correctly. It is possible to even lose more money that invested because trading options is a complex affair. Trading can therefore be an ominous and intimidating task. More traders lose money that those who do make money. The main challenge is in understanding the complex nature of options. Learning how to trade options is possible but it is a process that takes both commitment and time. Only traders who are dedicated and invest their time and effort will be rewarded with success.

Trading Options is a Risky Venture

Options trading process is considered an extremely risky affair. Basically, all investment opportunities and even trading ventures carry a certain element of risk. The traders most at risk are beginners and novices. These groups are generally not as well versed or sufficiently experienced to deal in options. Knowledge is crucial in options trade but experience is absolutely essential. Rather than hemorrhage money, traders prefer to avoid options trading altogether.

Yet options trading process has been popularly utilized in the management of risks. Traders with stocks and other securities often buy options in order to protect themselves from inherent losses. Let us say a trader is holding stock ABC and predicts that its value will fall by 30% in the next one month. This trader has two options in this case. The first one is to sell the stock and hope to attract a great price. The other is to purchase a call option as a form of hedging against any market risks.

Trading options is a highly risky venture. Even seasoned traders sometimes lose money. Chances of making huge profits exist but chances of losing large amounts also exist. It all depends on the strategies applied, a trader's experience, and amounts involved. Trading options can be a highly risky venture mostly for inexperienced persons.

The best advice is to learn as much about trading options as possible and understanding the basics as clearly as possible. Plenty of practice also helps. Traders with little or no experience need to put their skills to practice as often as possible. There are plenty of platforms that provide dummy trading platforms where prospective traders can try out different strategies.

There are also plenty of tools and solutions that make options trading easier. All these when applied to different strategies can result in better performance at the markets. Once the basic strategies are well understood and practiced sufficiently, a trader can then proceed to implement and finesse them until the confidently execute them flawlessly. This is how a trader goes from beginner to novice, to advanced, and eventually professional trading levels.

One of the most prohibitive factors about trading options is its complex nature. Numerous numbers of traders avoid options because they are difficult to master. The basics are quite okay and relatively simple to comprehend. However, they have a limited scope as well as limited profitability.

Real profitability lies in the compounded strategies which can be quite complex. This is why learning as much as possible about options can be really profitable. Plenty of excellent traders have seen their fortunes turn around by simply applying these strategies after taking months and sometimes years to perfect them.

Additional Risks Trading Options

Option traders choose this path largely due to the inherent versatility and flexibility. Options also offer a wide variety of strategies each of which can be used depending on circumstances and market conditions. There are a number of strategies that can help prevent or limit some of the risks inherent in certain positions in the markets.

There are trades with known pathways and with limited risks. This means that it is possible for a trader to enter a position and be able to determine the outcomes of that position. However, trading options is the exact opposite as there are numerous ways a trade could go. And trades can go wrong and when they do, then traders

stand to lose significant sums of money.

Take for instance a trader who intends to spend $1,000 trading options. A contract usually costs about $1 or $2 so the trader can purchase about 500 contracts. If the stock was to rise and gain in value then he would earn a tidy profit. However, if the stock was to lose money then the trader would lose out big time. And if at expiry the stocks did not move, then the trader will lose the entire $1,000 which is the cost of buying the options contracts.

Complex Nature of Options

We have already determined that options trading process is a complex affair. By its very nature, options trading process is a kind of derivative. Derivatives introduce some complexities because prices and trends of the option are not derived directly from it but from a security. Each is distinct but closely related. Think of options securities as securities that derive their value from elsewhere.

Sadly, a lot of traders do not quite understand or comprehend the complex nature of options trading. As such, they take a wrong view and end up losing money at the markets. It is highly advisable that any option trader takes the time to learn as much as possible about options and how they function.

Thorough understanding begins with learning the basics of trading options. Building up from there is relatively easy even though it is a process that does take time. Therefore, prospective traders should take the time to learn as much as possible about trading options and then put all this knowledge into practice.

Sometimes options traders will find that they need to deal in large volumes for any trade to be viable. If volumes are not sufficiently large then the trades may not be viable. As such, challenges may emerge such as liquidity and risks. Very small volumes would be okay should the trades be possible. However, a challenge is posed when large volumes have to be traded.

When should you Use Options?

As an investor, you will have a number of opportunities to use options. However, there are a number that are truly beneficial. Here is a brief look at them.

- Options buy you time if you need to sit back and watch things develop
- You require very little funds to invest in options compared to buying shares
- Options will offer you protection from losses because they lock in price but without the obligation to buy

Always keep in mind that options offer no free ride or a free lunch. Trading in options carries some risks due to their predictive nature. Any prediction will turn out one way or another. The good news here is that any losses that you incur will only be equivalent to the cost of setting up the option. This cost is significantly lower than buying the underlying security.

Fundamentals of Options

Types of Options

Most traders and experts who regularly hear about options know only about stock options. However, options can be written on just about all kinds of financial products. These include commodities, currencies, bonds, stock indices, futures contracts, and much more.

When it comes to stock options, there are only certain types that are accepted for options trading and not all. For a company's stock to qualify, then it must meet certain qualifying criteria. The criterion is set by the exchange where the stock is traded. As long as the criterion is set, then the stock will be eligible. However, when it fails, then it gets disqualified.

Sideways Market Movement

If you want to trade options successfully, then you need to identify the strategies that will enable you to benefit should the markets move sideways rather than upwards or downwards. There are certain strategies that will enable you to benefit from such strategies.

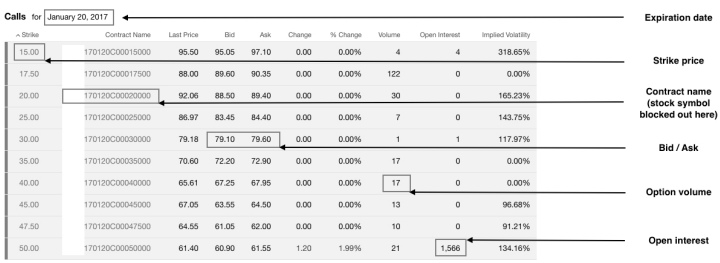
Most traders dislike this market condition because they like the knowledge of strategies they can implement to benefit them. Yet as a seasoned trader, you need to actually have strategies that can ensure you are profitable in such circumstances. Using options, it is possible to make money even with almost zero movement in the

markets.

Most of the time traders consider selling premiums when there is no movement. You can use options to achieve this effectively. For instance, strategies such as calendar spreads and iron condor are effective in sideways market movements. Others include sale of strangles, straddles, and vertical spreads.

Learn to Read an Options Table

Some of the crucial things that you need to learn include how to read an options table. As it is, the values of options are determined by a number of factors including distance between market valuation and contract initiation and the strike price, volatility of asset price, time till expiration, and others. Greeks are created by models that are the values determining the relationship between an underlying asset and the option price. It is these relationships that make options tables valid.



You will find out that a lot of the time, the market's attention is often focused on options trading. If you learn how to read the table properly, you should then apply your skills on paper before then applying your skills and techniques to actual or demo trading. Make sure that you engage in demo trading before live trading using real money. When you apply your skills and techniques on a virtual trading platform, you will successfully be able to apply these same techniques to other situations on the live trading platform.

Acquire as Much Experience as Possible

Basically, the more you trade in options the better you become. You improve your skills and gain more exposure to different trading conditions. As such, you gain the necessary techniques and knowledge that help to make you a better trader. For instance, you will get to learn about certain techniques that can save you money.

A good example is placing entries right between the bid and ask spread. This will not guarantee an instant fill but you will be able to save a significant amount of cash by doing so.

Option trading is an incredibly powerful investment strategy. By learning some of these powerful trading strategies and tips, you will be able to make plenty more money from your trades and benefit from all kinds of market conditions.

Basic Types of Options

Options trading constitute a type of contract that is entered into between a buyer and a seller. The contract involves a right but without an obligation to sell or buy an underlying asset. Options can be described as a type of derivative because their values are obtained from an underlying asset. Options are generally classified as either calls or puts. Thus we have call options and put options.

A call option is an option that assigns its holder the right but not obligation to purchase the underlying security at a certain agreed price and within an agreed period of time. On the other hand, a put is an option that awards its bearer a right to dispose of a financial security at a set amount in a given period of time.

We have additional terminology used when dealing or trading in options. For instance, we have the strike price. We define the strike price as the price or cost of the underlying security. This is the price at which it can be sold or bought. However, the total price is called a premium. There are a number of factors that influence the premium including the stock price, the strike price, and the time value.

1. Call Options

Call options are options contracts agreed between a buyer and seller. The seller usually holds certain securities such as stocks, bonds, currencies, and so on. The buyer usually wants to have some form of leverage including buying or benefiting directly from the security held by the seller.

An options writer will write the contract and sell it at a price. This price ranges from $0.5 to $5 depending on the value of the underlying stocks. This amount is paid upfront by the buyer and is

non-refundable. The options writer gets to keep this amount as their reward. A trader who buys an option simply earns the right to buy or sell the underlying asset. However, there is no obligation to do so. The contract has a definite expiry date while the underlying security has a pre-determined price. A call option generally gives the buyer the right to purchase the underlying security.

An Example

Call options can be viewed as a down payment for a future transaction. For example, a property developer desires to put up an apartment block in a certain area. However, he will only do so if the city makes certain changes. The developer then decides to put a down payment on the property using options. The call option stated that, if the city made adjustments to the by-laws, he will purchase the land at a certain price.

If this does not happen within a certain period of time, then he will abandon the idea. He pays a fee for the call option. This is exactly how options work. They can be used for hedging purposes with the buyer receiving a right, but an obligation, to purchase the underlying security. The price that is paid for the option is known as the premium.

Another Call Options Example

A call option can also be considered as insurance for future use. For instance, let us assume you wish to purchase a home in the future then you notice a new development coming up. You can decide that you wish to have the right to purchase a home on the development. However, you wish to peg your decision on the development of additional amenities in the area such as schools, parks, malls, and so on. It is possible that an airport could be put up or a garbage dump.

Such decisions can help you decide whether or not to invest your money in the development. So you speak to the developer and make him a suggestion. That should certain amenities be built in the area, then you will purchase an apartment at, perhaps $350,000 within 3 years. The property developer may agree with you but will not grant you this for free. He will charge you a fee for this, probably 1% of the home's value or $3,500.

Suppose that after three years, the development is complete and the amenities you desired were put up. You will then approach the property developer and exercise your right to buy property at the agreed price. By this time, the price of an apartment is probably double, at $700.000. You will have saved yourself a whopping $350,000 by using options. In any instance, the property developer will keep the $3,500 which was the cost of setting up the option.

Let us assume that a different situation happens and the city neglects putting up the desired amenities but instead puts up a dumping site. If you decide to forego your right to purchase an apartment, then you will be free to do so. However, you will lose the price of the contract which in our case is $3,500. This is a relatively small price to lose yet the benefits you stand to gain are significantly high.

Another Example of Options Application

Let us say there is a company that you really like and you would like to own its shares. According to your predictions, the stock price is going to rise. For instance, the current stock price of this company is $25 but you believe the price will be $35 in a year's time. You can purchase a call option that will grant you the rights to purchase the stock.

On the contract, you can agree on a price of about $27 within the next one year. This contract will probably cost you about $1 per 100 shares. Now if the price does get to $35 as predicted, then you can exercise your right to buy the shares at $27. However, if the price remains constant or falls, you will not be obliged to buy and the only loss you will incur is the options fee.

2. Put Options

Put options are option contracts where a seller enters into an agreement with a buyer concerning an underlying asset. In this instance, the seller has an obligation to sell the security should the buyer choose to exercise their right. This is the major difference between a call option and pull option. A call option buyer has the right but no obligation to buy the underlying security. On the other hand a put option seller is obligated to sell should the buyer exercise their right.

Put options happen to be the complete opposite of call options. The buyer in this instance gets the right to sell the underlying security. The seller on the other hand is obligated to purchase the stocks without the chance to opt out. Both put and call options have an expiration dates. The underlying security determines the price of the option but other factors are also considered.

Learn about Buying and Selling Call and Put Options

Long Position

When you buy stock, you get what is known as a long position. When you buy a call option you get into a potential long position based on the underlying stock.

On the other hand, when you sell a stock short, then you are short-selling. This essentially gives you a short position. Short selling means that you sell at a loss while long selling implies a profit. When you sell a naked call or an uncovered call, you will enter a potentially short position based on the underlying stock.

Short Position

You enter into a potential short position based on the underlying stock when you purchase a put option. Should you sell a naked put, you will enter a potential long position relative to the underlying stock.

If you can understand these four positions and keep them in mind, then you will easily understand the intricacies of selling and buying options. Ideally, you can buy call options and put options as well as sell call options and put options.

Holders: Anyone who buys options is generally referred to as an options holder

Writers: A person who sells an option is generally referred to as an options writer

Call and put holders are also known as buyers. They have the right to buy options but are not obligated to do so. They can exercise this right but only within the stipulated time and under the agreed conditions. This way, call and put holders only suffer losses equivalent to the premium charged for the options contract.

Call and put writers are sellers. They have an obligation to sell options or buy should the option expire and the contract makes money. Therefore, sellers are always expected to oblige to the buyer's wishes. This exposes them to more risks. Therefore, writers stand to lose a lot more than just cost of writing the options contract.

Common Terminology Affiliated with Options

If you are to successfully trade in options, then you really need to understand basic terminology. Learning a couple of key terms will enable you become more conversant with options. Here is a look at key terms that are essential for options trading.

Options type: There are generally two types of options that you can sell or buy. These are call options and put options.

Strike Price: The strike price is also known as the exercise price. This is the price that you will sell or buy the underlying stock should you choose to exercise your options.

Expiration Date: The options contract is not indefinite and has an expiration date. The expiration date refers to the date when the contract entered into becomes void or expires.

Premium: This term refers to the price you pay for the option. This price is charged per share which means it will depend on the number of shares you sign up to. Premium has different components to it. These are the intrinsic value and time value of an option.

Intrinsic Value: This is the value of an option and refers to the difference between the underlying stock's strike price and its current market price.

Time value: The time value of a share refers to the amount of time that is available before an options contract expires. The time value decreases as the expiry date approaches.

Time decay is the term used to express the approach of the expiration date. As this time decay progresses, the time value of an option decreases. Time decay is also commonly referred to as "theta". This time is derived from the pricing model that was used to calculate it. Time is very valuable to investors hence the importance of time decay.

Additional Options Trading Terminology

Listed options: A listed option is any option that qualifies for trading at a national trading platform like the Chicago Board Options Exchange, CBOE. A listed option generally represents 100 shares of a particular stock. Such an option with 100 shares is also referred to as 1 contract. Each contract has fixed expiration dates and strike prices.

In-the-money: A call option is said to be in-the-money when the share price exceeds the strike price. On the other hand, a put option is said to be in-the-money anytime the share price falls below the strike price.

The price, or total cost, of any option is referred to as the premium. It is affected by a number of factors including volatility, time value, strike price, and stock price.

Contract names: Options contracts do have names or options symbols similar to ticker symbols for stocks.

Ask price: This is the asking price that a seller will accept to trade the option. Basically, should you wish to purchase options, then this would be the premium that you would pay.

Volume: This refers to the total number of contracts that get traded in one day

Change: This refers to the difference in price from the previous to the current trading period. Sometimes change is expressed in terms of percentage.

Volatility: Volatility is simply the measure of a stock's price swing measured between the low and high prices of each day. For a long time, volatility has been measured using past data.

IV, also known as implied volatility, measures the likelihood that a market considers a stock will experience significant price swing. There are certain tools that are used to measure some of these parameters. One of these is Vega. Vega is a pricing model that calculates the theoretical effect of a single point change on implied volatility.

When the implied volatility is high, it means options prices will be

high due to potential upside for the options contract. It is good to keep in mind that volatility measurements are only estimates and never accurate. They are mostly predictions on the expected change of an option's price.

Employee stock option: While these are not readily available for all traders, they are a type of call option. Plenty of listed companies offer stock options to their treasured and talented staff members, especially management, in order to retain them for a long period of time.

Employee stock options are very similar to ordinary stock options as a holder receives the right, but not obligation, to purchase stocks at a certain price and within a stipulated time period. However, the contract only exists between the company owners or board and an employee. Others cannot trade or exchange it at the options stock markets.

This is different however if the options are listed. A listed option represents a contract between two different parties. This contract is completely unrelated to the company and easily be traded at the markets.

Terms Describing an Option's Value

We do not describe an option's performance as up, down, or level. This kind of description is not sufficient. Instead, we can definite performance in one of three distinct ways.

In the money: An option that has intrinsic value is said to be in-the-money. Basically, anytime that a stock's price in the stock market and the strike price both favor the contract owner, then the option contract is said to be in the money. Essentially, it is beneficial to the call option owner when the stock price is greater than the strike price. On the other hand, a put option is said to be in the money when the price of the stock is less than the strike price.

Out of the money: An option is said to be out of the money when there is absolutely no monetary gain expected in exercising it. This means it is a lot less lucrative or financially viable to sell stocks and shares at the strike price than it would in the general securities market. Therefore, we say that a call option is out of the money is

the strike price is higher than the stock price. A put option on the other hand is said to be out of the money anytime that the stock price is high than the strike price.

At the money: Sometimes the strike price is just about equal to the stock price. In such a situation, we say that the option is at the money.

Options Seller and Buyer Terms

There are special terms used to refer to options traders. In other situations we'd refer to the traders as buyers and sellers. However, when it comes to options trading, a more technical term is used.

Writer: The term writer refers to an investor who holds an options contract and is selling it. When the writer sells the option, they will receive a premium from the buyer. The buyer will be buying the right to buy a specific amount of shares at a strike price.

Holder: A holder is basically an investor seeking to purchase an options contract. A call options holder will buy an options contract and gain the right to purchase the underlying stock under stipulated terms. A put holder possesses all the rights to sell the underlying stock.

A holder and a writer are generally on opposite sides of an options transaction. One writes an option while the other signs up to it. However, the main difference between these two is the kind of losses they are exposed to.

Holders sign up to get the right to purchase or sell shares but without the obligation. The contract that they sign up to grants them the choice of if and when to exercise their right. If the option, over time, becomes out-of-the-money, then they have the freedom to abandon the contract and let it expire. In such an instance, they will only lose the premium paid to set up the options contract.

On the other hand, things can be a little different. For instance, writers lack this kind of flexibility. If a call options holder decides to exercise their right, then the writer is obligated to accept the order and execute it by selling the stock at the current strike price.

Should the writer not be in possession of all the shares in a contract, then he or she will have to purchase these at current

market rates and sell to the holder at the strike price. If there are any losses to be incurred, the writer is obligated to take on them. Since the risks are pretty high for writers, it is recommended that beginners confine themselves to only buy stock options until they gather sufficient experience over the years.

Chapter 2:
Understanding How Options Work

Buying and Selling Call and Put Options

There are only a few things that a trader can do with options. Options contracts such as call and put options can be sold, or purchased. Therefore, a trader can buy call options, sell call options, purchase put options, or sell put options.

A trader that buys stock options assumes a long position. Purchasing a call option means that a trader potentially assumes a long position in the underlying security. In the same manner selling a stock option means the trader has a short position. The same is true when a trader sells an uncovered or naked call option because the trader then assumes a short position.



American vs. European Options Styles

American Style Options

When it comes to trading options we have two distinct options styles. These are European style options and American style options. American style options refer to the terms of an options contract. It does not necessarily refer to the country or continent where the sale took place.

Each options contract comes with certain features including an expiration date. It is upon this expiration date that the buyer gets to

exercise their right to purchase the underlying stocks. In the case of a put option then the buyer will reserve his right to sell the underlying security.

The distinction between the two comes in here. When it comes to American stock options, the contract owner or buyer has the right to exercise it at any time. The contract does not have to expire for rights to be enjoyed. This type of contract is extremely flexible and provides traders with many benefits and opportunities which they can rightfully exercise.

European Style Options

European stock options are similar to all other options. The only challenge is that they are not as flexible. The American style options are flexible because they allow the buyer or holder leeway to lay claim to the underlying stock/ the European style contracts accord rights to a buyer but these rights are only exercised upon expiration of contract between seller and buyer. The rights cannot be exercised or enjoyed prior to the expiration date.

Traders will only be able to enjoy their rights upon expiration of the contracts. At such points, they may choose to exercise their rights or forfeit them. Most options contracts are of this kind. Many that are traded across the world are of this nature where parties have to wait a couple of days or weeks until the contract is about to expire.

Buying and Selling Call and Put Options

Long position

When you buy stock, you get what is known as a long position. When you buy a call option you get into a potential long position based on the underlying stock.

On the other hand, when you sell a stock short, then you are short-selling. This essentially gives you a short position. Short selling means that you sell at a loss while long selling implies a profit. When you sell a naked call or an uncovered cal, you will enter a potentially short position based on the underlying stock.

Short position

You enter into a potential short position based on the underlying

stock when you purchase a put option. Should you sell a naked put, you will enter a potential long position relative to the underlying stock.

If you can understand these four positions and keep them in mind, then you will easily understand the intricacies of selling and buying options. Ideally, you can buy call options and put options as well as sell call options and put options.

Holders: Anyone who buys options is generally referred to as an options holder

Writers: A person who sells an option is generally referred to as an options writer

Call and put holders are also known as buyers. They have the right to buy options but are not obligated to do so. They can exercise this right but only within the stipulated time and under the agreed conditions. This way, call and put holders only suffer losses equivalent to the premium charged for the options contract.

Call and put writers are sellers. They have an obligation to sell options or buy should the option expire and the contract makes money. Therefore, sellers are always expected to oblige to the buyer's wishes. This exposes them to more risks. Therefore, writers stand to lose a lot more than just cost of writing the options contract.

Practical Example of Options Application

Let us say there is a company that you really like and you would like to own its shares. According to your predictions, the stock price is going to rise. For instance, the current stock price of this company is $25 but you believe the price will be $35 in a year's time. You can purchase a call option that will grant you the rights to purchase the stock.

On the contract, you can agree on a price of about $27 within the next one year. This contract will probably cost you about $1 per 100 shares. Now if the price does get to $35 as predicted, then you can exercise your right to buy the shares at $27. However, if the price remains constant or falls, you will not be obliged to buy and the only loss you will incur is the options fee.

Buying and Selling Call and Pull Options

As it is, there are four distinct things that traders can do with options. They can buy call options, sell options, buy put options, and sell put options. When a trader buys securities, they generally assume a long position. However, buying options only introduces potential which means traders assume potential long positions with options.

Similarly, selling short a security introduces a short position. In the same way, selling an uncovered or naked call option introduces a potential short position. These are basically the four main situations that options traders can expect to encounter.

Call and put holders are also known as buyers. They have a right but no obligation to sell or buy their options contracts. They can choose to exercise their inherent rights or decide not to do so. This will depend on a number of factors such as the reasons for trading options and so on. It also introduces a limit to risk exposure so that only the premium can be lost.

Those who write call and put options contracts on the other hand have an obligation to sell the underlying security should the buyers choose to exercise their rights. This is bound to happen should an option expire in-the-money. The seller will be expected to fulfill an obligation entered into with the buyer.

This also helps to minimize the risk to the buyer while exposing sellers to almost unlimited risks. Options writers are prone to losing a lot more than the profit they receive from premiums.

There are various reasons why traders and investors use options. Here is a look at some of these reasons. Understanding them is crucial as it demonstrates the practical application of trading options.

For Speculative Purposes

There are those who use options for speculative purposes. Speculation can be termed as a bet or wager regarding price direction in the near future. Speculators are of the opinion that the price of a security, and in some cases assets, will go up or down in the coming months. They arrive at this conclusion based on

technical or fundamental analysis.

Based on their predictions, a speculator will then choose to purchase the stock or better still buy call option based on the said stock. A lot of traders prefer speculating via options as they get to enjoy some leverage. A trader could end up spending much less if they opt for options rather than buying a stock directly.

Options for Hedging Purposes

The main purpose for trading options is hedging. Hedging is a technique used by traders and all other individuals, organizations, and especially business owners to protect their investments against future shocks. For instance, an airline may hedge on the price of oil for purposes of obtaining favorable oil prices should prices rise in future.

This is why experts also view hedging as a form of insurance cover. People insure their cars against hazards, homes against disasters, and so on. Hedging provides another way of protecting an investment while minimizing and even limiting potential losses. This is where options come in handy. Options provide traders, and any other person for that matter, with an opportunity to limit risks on the downside while benefitting from the upside through a cost-effective manner.

How Options Work

When it comes to options contracts, the crucial part is the determination of future prices. It all comes down to probability which means the likelihood of a particular event to occur. For instance, in our airline hedging example, a future price had to be determined. The price had everything to do with probability.

How likely is it that fuel prices will go up in the coming weeks or months? Based on probability of outcomes, the price can then be determined. We can as well use a call option for instance. The value of such an option goes up with the value of the underlying stock. This is where relative value of an option comes in. Options are more valuable the more time they have. When they approach expiration, they lose value pretty fast until they become worthless.

Options do not just diversify your portfolio but they also provide

you with immense opportunities of earning large profits with minimal income. Before you can begin trading options, you need to understand the process of buying and selling. You also need to learn how to read tables where options are quotes are printed. There are symbols used when quoting options and tables that consist of complex array of numbers.

A lot of traders, both small and large, prefer options trading to grow their wealth and benefit from higher profits. This is achievable with relatively small amounts of funds. The profits earned via options are disproportionately large compared to the investments made. One benefit of this type of trading is that you are able to begin small and grow large very fast. With amounts as little as $80, a small retail trader is able to invest in options and see gains very soon.

Probability

Option trading is a very versatile process. This opens up a whole new world of opportunities. You could use options basically to trade and earn profits, for leverage and also as insurance or protection against potential losses. All these can be attained conveniently and very quickly.

Because trading in options is a very powerful process, it is also a very risky one. It is also very dangerous and can get out of hand if not handled carefully. It is crucial that traders and investors understand exactly how to trade options and lots of other details. Getting sufficient knowledge and enough practice is crucial if you are to be successful and consistently profitable.

An option contract can be more expensive at a certain time of the year compared to another time period. This is often due to a feature known as time decay. The less time an option has to expiry the less value it has.

As a matter of fact, an options contract with a distant expiry date is more valuable and will be charged a much higher premium compared to contracts that expire much sooner. As such, all options contract have a time factor where time is always running. With each passing minute, an options contract loses some of its value. This is a process known as time decay. Within a short period of time, the value of an options contract will be worthless due to time

decay.

Volatility

Another factor that has a huge effect on options is volatility. Volatility tends to raise the option's price. Basically, what happens is that there is uncertainty because that is what volatility does. Large price swings are likely to appear should the price of the underlying security increase.

Large price swings tend to increase the probability of something happening. If there are substantial movements in the underlying security, then it means that if the movements are large enough, it would affect the price. As such, volatility is one of the largest and most important aspects of trading options.

Triggers

One of the first things that you need to do after placing a trader is to dial down for triggers. This is one way of managing risks and lowering your risks. When you lower down your risks, you improve your chances of success and as such you can go for a great size.

To achieve this successfully, you will need a chart that makes use of Fibonacci symmetry and retracement. Such a chart will have a slanted line and an upper line. Find the upper line because it is the trigger line. This line basically indicates or points to the nearest level that has to be broke just so you may continue with the upward trend.

As a trader, you should endeavor to identify a pathway to enter the trade at a point that is nearer to the market's determined turning point. In order to find such an entry point, you will basically do what is known as down dialing.

Basic Options Trading Strategies

There are plenty of varied trading strategies that can be used to trade options. These range from the very simple trades to the absolute complex and exotic trades. However, regardless of how simple or how complex a trade is, it is essentially based on the basic call and put options.

Options trading can be a complex affair. It is definitely more

complex compared to traditional stock trading. Ideally, when buying stocks, you will determine how many shares you want and at what price then fill out a form so the broker can fulfill your order. When it comes to options trading, you will need these and a lot more.

We shall first examine five most basic strategies. These very basic strategies use only one option. Investors refer to them as one-legged strategies. While the strategies may be simple, they are by no means risk-free. They simply provide beginners with some of the best and easy ways to get started trading options.

The five basic options trading strategies

- The long call
- The short put
- The long put
- The married put
- The covered call

1. The Long Call Options Trading Strategy

The long call options strategy refers to the strategy in which you purchase a call option. Buying a call option implies going long. When you go long, you expect the underlying stock's price will rise and you stand to make a profit. Let us look at an example of this strategy.

Example

We have shares of company ABC trading at $50 per share and a call option with a $50 strike. The cost or premium of this share is $5 and the expiry period is after six months. Our options contract in this case is for 100 shares so the total premium cost is $5 * 100 = $500.

Potential benefits and downsides

Now you stand to benefit in a major way from this contract. For instance, if you time this call well, then your profits are almost infinite. This is as long as the stock price keeps moving higher. You could easily make profits of $5,000 or more in just a short while. However, the downside is that you stand to lose your premium of

$500. This is the maximum loss you stand to lose should share price take a nose dive. Even then you can still recoup some of these losses if you sell the stock before expiration date. Therefore, the benefit of using the long call strategy is that you losses are limited but the upside or profitability is virtually unlimited.

Why Adapt this Strategy?

There are a number of reasons why you may adopt this strategy. First, if you are not too concerned about losing the entire premium, then you able to leverage your predictions of the stock price rising so that you stand to earn much more than directly owning the stock.

You can use this strategy to limit you risk of owning a stock directly. Owning the stock directly can expose you to potential losses while using this strategy limits your risk of loss. Instead of owning a large number of shares from one company, some traders may prefer this approach.

Also, owning a stock directly requires a lot of financial resources compared to just using an option trading strategy. Remember that owning shares means buying them directly at face value but trading using stock options only requires payment of a premium.

2. The Long Put Options Trading Strategy

The long put trading strategy is very similar to the long call strategy. The only difference here is that you will be hoping that the stock price declines. Stock prices can rise or fall depending on a number of factors. If your predictions or analysis indicate that a stock price will fall then your best options strategy is the long put.

As an investor, you will buy a put option and then hope that your predictions are correct. Again, if your predictions are correct, then you stand to gain unlimited profits while your losses will be limited to the cost of setting up the option. This is best demonstrated through an example.

Example

Let us take company ABC whose stock has a current market value of $50 per share. According to your prediction, or analysis, the share price will fall in the next six months. Based on this, you discover

there is a put option at $50 strike price that is currently available at $5 per 100 shares. This option has an expiration period of six months.

Now the call option charges $5 per 100 shares. If you intend to invest in 100 units of shares, then you will pay a premium of $5 * 100 = $500. Your cost and potential loss will therefore be limited only to this amount. However, should your predictions come true then you stand to benefit much, much more.

What are the potential losses or benefits?

If you invest in a long put option trade, then you stand to benefit should your predictions turn out right. You will benefit the most if the share price falls to zero or $0 per share. When this happens, you stand to make $50 * 100 = $5,000.

Now should the price of the stock rise, you can still sell and recoup some of the funds paid for the premium. This helps minimize your losses. However, the maximum amount of losses that you stand to incur is $500 or the cost of the premium.

Why use this strategy?

This specific strategy provides an excellent opportunity to wager against an expected stock decline. Should the stock price decline be significant, then you stand to make much more money that through direct investment in the same stock. This is therefore one reason why you would wish to invest in a long put option.

There are traders who would wish to use this strategy in order to limit any possible losses arising from price fluctuations. For instance, if the price of a stock falls drastically, then the losses can be huge for any investor. However, mitigating the losses is possible with a long put option. The option provides a better alternative to short selling as the risk is high as the price of a stock could rise indefinitely.

3. The Shot Put Options Trading Strategy

Yet another basic strategy that is commonly used to trade options is the shot put. This strategy is basically the opposite of the long put. Remember that with the shot put, an investor is betting on the price of a stock rising. With this approach, you will be selling an options

put which is also known as going short.

This specific strategy is pegged on the chance that the price of a particular stock will either rise or stay level until the expiry of the option. It is expected that with this strategy, the option will expire worthless and, as the seller, you will earn a premium for absolutely free. This strategy, just like the long call strategy, can be set up as a strategy to mitigate a rising stock though there are some significant differences.

Potential Benefits and Downsides

Like with all other strategies, there are potential benefits and downsides to this particular strategy. A long call basically counts on a major rise in stock price, the short put option is a little more modest and the payoff is also modest. For instance, the long call has the capacity to return the original investment multiple times, the best that you can hope for with this specific strategy is 100% of the premium paid. In our case, this would mean keeping the entire $500 paid to you by an investor.

Now remember three different events are likely to take place. Basically, the stock price could rise, descend, or stay the same. Now should the stock stay at the strike price or rise above it, you get to keep the full premium amount. Remember that this is your aim with this strategy.

However, should the stock fall below the strike price at expiration of the contract then the stock will have to be purchased at a loss. The maximum loss that will be incurred should the stock price fall to $0 is $5,000.

Why Choose this Strategy?

There are a couple of reasons why traders pursue this strategy. The shot put strategy is largely used by investors who strongly believe, based on insights, past data, or analysis, that the stock price will go down. It is quite similar to someone seeking insurance because a seller will try to sell the premium so that they do not eventually have to pay any money should things not work out.

This strategy of selling shot puts should be sparingly used because it almost always ends up with investors buying shares yet this was not

a part of the initial plan. Any stock whose price begins to fall can very easily deplete any premiums that are received from the sale of option puts.

Investors sometimes adopt this strategy with the hope that the underlying stock's value will rise especially because the trade does not require any immediate financial input. However, this strategy is capped which means your profits are limited and any downfall experienced is quite substantial. Therefore, always proceed with caution whenever you consider using the shot put strategy.

You can also use this strategy to receive a preferred buy price when the stocks are too costly. You can do this by selling put options based on an underlying stock with a low strike price. The low price is likely to attract buyers who would love to invest in the stock. For instance, let us take company ABC whose stock price is $50. You can sell put options at a price of $2 per share for a strike price of $40.

In this case, if the stock price falls below the strike price upon expiration, you will receive the stock. The investor on the other hand will pay $40 per share, which is the strike price, less $2 per share which is the premium already paid.

However, should the stock price stay above the indicated strike price upon expiration then you will get to keep the premium payment and repeat the same strategy all over again.

4. The Covered Call Options Trading Strategy

This is yet another basic trading strategy that is sometimes used by both traders and investors. The difference here is that this specific strategy consists of two distinct parts. As an investor, you will need to first own the underlying shares then create a call option based on the underlying stock and sell it.

You will basically award the buyer all the benefit of price appreciation above the indicated strike price. When applying this strategy, you will assume that the stock price is likely to go down slightly remain flat until expiration. This will, in essence, allow you to keep the premium paid by the buyer and also keep the shares.

As the investor you will not only keep the stock but you are free to

repeat the process and write another call option if you so wish. There is a critical point that you need to note, though. For every 100 shares that you own, you will only be selling one single call. If you do not do this, then you will probably fall victim to short or naked calls and exposure to huge, uncapped losses in the event of the stock price rising.

Covered calls can transform an otherwise unpleasant option strategy, such as one with naked calls, into one that is safe for you and potentially rewarding. This is why sometimes this strategy is among the favorite for investors seeking to earn a regular income.

Any Potential Benefits or Cons?

Your profitability in this instance is limited to the premium paid by the buyer. In our case, the maximum premium amount is $500 so this is the maximum amount that you stand to gain should everything work out in your benefit. This will need the stock to remain at strike price or below.

However, should the stock price go up exceeding the strike price, then the option becomes a lot more expensive because it offsets most of the gains made by the stock. It also caps the upside which can mean low chances of profitability. Since the upside of this strategy is capped, you stand a high chance of suffering losses.

The problem here is that these are losses you would not have incurred had you not set up this option call. However, you do not get to lose any newly invested capital. The other challenge with this strategy is that you risk a complete loss of the stock's worth minus the $500 premium paid to you.

When is this Strategy Adapted?

You can use the covered call option if you are an investor seeking to generate income but with limited risk even as you hope the share price will remain flat or fall just a bit until expiration.

You can also use the covered call strategy in order to get a higher sale price for your stocks. You can do this by lowering the premium cost as well as setting lucrative higher strike price. These will entice potential buyers to actually decide to purchase the call option. For instance, if the price of the stock of company ABC is $50, you can

price these at a strike price of $60 then place a premium on each share of $2.

5. The Married Put Option Strategy

The married put options trading strategy is considered sophisticated, just like the covered call option strategy. Both are thought to be more sophisticated compared to other basic options trading strategies.

This specific strategy is considered more complex because it combines two approaches. These are ownership of the underlying stock and a long put. It is these two that are “married together” and hence the name of the strategy. It is important to note the implications of adopting this or any other strategy.

With the married put, you get to purchase one put for every 100 shares of stock. This particular strategy allows you, as an investor, to own shares and hope to benefit from rise in price.

It then goes further and offers you an opportunity to hedge your position should the stock price start to fall. This approach is quite similar to purchasing insurance as it charges you a premium to protect your investment from loss due to a decline in share price.

Possible Benefits and Downsides of this Strategy

The married put has some upsides to it. However, these depend on what happens to the stock price. Should this specific strategy allow you to continue with stock ownership as the price increases, then your profit level is potentially unlimited. All you will do is deduct the cost of the premium from your profits.

The option itself will benefit you if the price of the stock falls. This will essentially match any price decline and will offset stock loss less the premium which is capped at $500. As an investor, you are able to hedge against losses and keep holding the shares in the hope that the value will appreciate once the expiration date is attained.

Benefit of this specific put option strategy is that you can use it to hedge. As an investor, you will use this specific strategy if you are hoping that your stock price continues to appreciate. You also use the marriage put option when hoping to protect price gains that your stock makes as you hope and wait for further gains.

Chapter 3:
Understanding Options

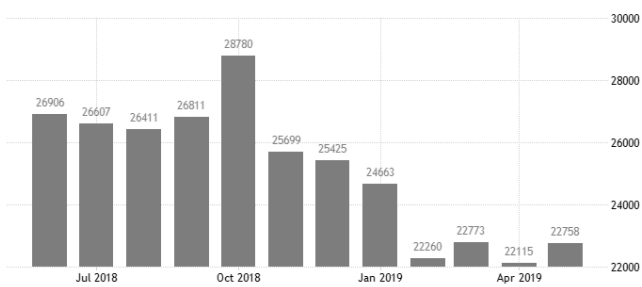
Different Types of Options

There are generally two major classes of options. These are put options and call options. Like previous defined, put options give you, the investor, an opportunity to sell stocks at a specified price while call options give you the option to buy stocks at a certain price.

Underlying Asset

Every option contract is based on an underlying asset. Most options are based on stocks of companies that are listed at the stock market. In recent years though, other securities have been used. These include REITs or real estate investment trusts, ETFs or electronically traded funds, foreign currencies, and stock indices. Some are even based on commodities like minerals, industrial, and agricultural products.

Stock options contracts are generally based on 100 shares of the underlying stock. Some exceptions are made in special cases for instance where mergers occur or when there is a stock split. Also, buying options is completely different to investing in shares. Here is a look at different types of options.



Different Types of Options

- The Protective Put - Stock Options
- Weekly Options - Mini Options
- Index Options - Mini Index Options
- Futures Options - ES Weekly Options

- Binary Options - E-Mini Options
- IRA Accounts - ETF Options
- Near month in-the-money options

1. Near Month In-the-Money Options

Some options are best suited for day trading. One such example is the near month in-the-month option. This option basically refers to options contracts that are set to expire at the close of the next month. Such options are usually past their strike price so investors are free to exercise them.

The inherent value of this options contract is one of the determining factors of the premium especially when it nears its expiration date. Such options are often traded in large volumes and this causes a smaller gap between the asking and bidding prices. As the option nears its expiration date, its time value diminishes.

2. Protective Put Option

The protective put is an option that is used by traders who wish to purchase both an option and its underlying securities. This is the preferred strategy anytime that the underlying stock is expected to undergo periods of high volatility.

There are instances when day traders will continually buy and sell the same stock option for a long time, maybe a couple of months, in order to benefit from short term upward trend. At other times, day traders make use of a strategy of purchasing put options on the same underlying security just so they insure themselves against any sharp losses in the stock's price. This is considered as a risk management technique. While there are certain small loses paid in order to protect the share, the opportunity to minimize losses on a downward trend is absolutely invaluable.

3. Stock Options

Traders acquire a way to increase their profits through straightforward stock options by simply purchasing or shorting shares at a certain set price at a set date at the options market. Day traders have certain advantages when it comes to stock options because the parameters are applied to stock options. Since both stock options and stocks are traded on an exchange, the market will

have the same liquidity and will enable fast execution of orders. Sophisticated investors can use options as an effective hedge against risks.

Stock options have the potential to cost you 100% of your funds. Brokers only permit sophisticated traders to deal in complex options systems like stock options. You can be exposed to enormous amounts of risk and it is crucial that you avoid strategies that require substantial experience. But its good to note that day traders rarely sell options.

4. Weekly Options

Weekly options are also popularly referred to as weeklies. Such options are generally listed with only one week left to expiration. Most options often have several months and sometimes even years to expiration. However, weeklies are generally available to day traders. They are found on ETNs or exchange traded notes, broad-market indices in the US, and ETFs or exchange traded funds.

A lot of traders view traditional options are a huge setback largely because of the long time duration. These traders very much prefer weeklies and view them as major game changers. They get to apply leverage of options even as they engage in more short-term strategies.

Created on Thursdays

Weekly contracts are usually created once each week on a Thursday. They remain valid until the following Friday for ETNs, ETFs, and equities. Weekly index options however, often close their final trading sessions on Fridays or Thursdays depending on the index. These basically have a total lifetime of seven trading days or one week.

As a day trader, you can benefit hugely if you take advantage of the increased volatility that comes with the time decay and expiration that is associated with options. Weekly options have 52 expiration periods throughout the year and this increases your chances of benefiting from expiring options.

While weeklies provide a couple of advantages to day traders, they have some possible disadvantages especially due to time factor.

Option buyers generally pay a lower price for the cost of a weekly option compared to regular options they usually experience a hugely limited opportunity window especially when trades move in the opposite of the intended direction. There is generally very limited opportunity for price recover and it is hard to fix a trade through strike adjustments.

5. Mini Options

Mini options are actually options that let traders and investors trade in options that are based on 10-share sets rather than the standard 100-share sets. Mini options have expiration dates that are similar in nature to regular expiration dates. This expiration date is also similar to quarterlies and weeklies.

Other features like the bids, strike price, and offers are also similar and correspond to features of regular options. However, they do offer certain benefits. As a trader, you stand to enjoy the following benefits by simply trading in mini options.

Benefits of Mini Options

- You are able to hedge a position for very little money
- Mini options are more affordable per transaction
- They can be exercise on any business day as long as they are not expired because they are American style in nature

Sadly, they also have some drawbacks. For instance;

- Mini options are available for only limited securities
- They have much lower liquidity
- The bid – ask spreads are much wider
- They charge a higher commission based on percentage

In general, mini options act as a great tool for hedging highly valued securities and for day trading. However, their use in day trading is limited unless they are available on a bigger variety of ETFs and stocks.

6. Index Options

We also have another type of options contract which is known as the index option. These options let you make use of put or call options to speculate on the movements of a whole stock market index like the S&P 500 or the Dow Jones instead of individual

stocks and shares.

A trader who trades index options can capitalize on their predictions based on volatility or direction of an entire market without any need to trade options based on individual stocks. One of the main challenges that traders encounter when pricing index options is accurately calculating dividend estimates.

Features of index options

- Basically, index options are less vulnerable to volatility compared to stocks in general that constitute an index
- Index options are well able to handle fluctuations that individual stocks could b exposed to and as such, they tend to be more stable compared to other kinds of options
- A lot of index options are exercised in a European style. This is because they cannot be traded until they expire. However, the trader or investor will not necessarily be stuck with them as they can be sold or bought as long as they haven't expired
- Index options often trade in large volumes because they are largely traded by investment firms, hedge funds, and individual traders
- Unfortunately for day traders, large volumes minimize the spreads quoted at the markets

7. Mini Index Options

The mini index options happen to be quite similar to ordinary index options. However, they cost 10% less and are only 10% the normal contract size. Traders and investors with limited capital are easily able to trade this option type and benefit from trading on the general market. Day traders benefit from this option type as they are able to have a wider strategy scope.

There are certain benefits or advantages of the mini index options. Here is a look at some of these benefits.

- They are a lot cheaper compared to ordinary index options
- They resemble the underlying index perfectly
- They generally offer a partial hedge against ordinary index options

There are some disadvantages as well. Some of these disadvantages include;

- Mini index options have a large bid – ask spread
- They usually have a higher extrinsic value due to lower liquidity
- Are a lot more expensive compared to others

8. Binary Options

Binary options are among the most commonly traded options. They are known by different names depending on the platform where they are trading. For instance, binary options are referred to as FROs or fixed return options when traded on the American Stock Exchange. On the Forex markets they are referred to as digital options and sometimes as all-or-nothing options on the ASE or American Stock Exchange.

The reason why they are known as binary is because this options class offers returns or profits in two outcomes. This means you get something or nothing. In this instance where you have binary options, the profitability is usually a pre-set amount such as $100. There are certain assets that can be traded as binary options. These assets include;

- Stocks
- Commodities
- Currencies
- Stock indices

While there are plenty of different types of binary options, only two are commonly used by day traders. These popular binary options are;

- Asset or nothing binary options
- Cash or nothing binary options

The asset or nothing binary option pays the entire value of the underlying security. The cash or nothing binary option pays an investor a set amount of money should the option be in-the-money upon expiry. This is the reason why this type of options is referred to as binary. You can expect to receive only one of two outcomes investing in this particular options class.

The reasoning behind binary options day trading is pretty simple. As a trader, the aim is to enter a trade position and exit before the close of the trading day. All binary options contracts come with expiry times and dates. This means that most binary options contracts have a set expiry date except on trading platforms where traders have variable expiry on options.

As a day trader, you should identify expiry dates that will conclude trades within the same day. This is because once you enter a trade that has an expiry date, you will not be able to exit manually the same way that you do with all other options trades.

Predetermined Profits

When trading in binary options, you will already know what you potential profit will be. This is because the potential profit is always already pre-determined. Also, binary options can be applied to almost all types of securities and financial products as puts or calls.

This is why day trading with binary options is considered easy and quite profitable. As a trader, you can expect high returns that are paid out almost immediately. Apart from the high profitability of binary options, there are other advantages that they offer;

Additional benefits of binary options

- As a trader you get to select variable expiry times to fit with your strategies
- There are no brokers so you will manage your own trading account
- You can trade diversified options at the same time
- You are allowed to make multiple small investments which is similar to day trading but with limited risk exposure.
- One trade can be sufficiently profitable to counter previous losses
- As a trader, you have trading opportunities throughout the day with no downtime
- With binary options, the potential to make profits is high and the turnaround times are remarkably fast

- Day traders have constant new opportunities as binary options markets keep expanding

- Security is high on these platforms largely due to the nature of private trading in the options trading market
- Volatility is not a big issue because risks are transparency and also options have short time frames

If you want to be a smart trader, then you should ensure that you follow patterns and trends in the market. When you can identify a true trend, then you will be able to attain profits regularly on a continuing basis and with need of changing strategy. However, should the trend fail to work because it was false or due to brief trading times, then you should exit the trade to minimize losses.

9. Futures Options

Options on futures are contracts that are focused on one futures contract. As a buyer, you reserve the right to choose a futures position on an index, currency, commodity, or other financial price. The options trade is at a specified price known as the strike price and you maintain your right until expiration of the option.

A future options seller is obligated by the contract to assume the reverse futures position as soon as you exercise your right. These options trades are dealt on the same exchanges with traditional futures contracts. The options contracts concisely match the underlying securities, which in this case are futures contracts. The matching is in terms of strike price, expiration dates, and quantities.

There are certain differences between futures and options futures. As an example, buyers and sellers have different obligations. It is advisable to find out more about the differences between options on futures contracts and futures contracts.

Futures Contracts

When it comes to futures contracts, then you as the buyer will take on the obligation of purchasing a particular asset at a set date in the future. Your seller is obligated to sell and then deliver the specific asset at that future date unless your position closes well before the expiration date.

Futures contracts generally do not have any initial costs. This is in contrast to other options contracts that have some upfront costs. Also, the underlying position has a much larger size. Any profits

earned are credited to the futures account right at the close of trading day. As such the value of the asset gets recorded based on its market price.

Options Based on Futures Contracts

Options that are based on futures grant you, the buyer, the right to sell an underlying security at a price that is predetermined. As a buyer, you are allowed to exercise your right to sell this asset as long as the contract is valid and not expired. However, in this instance, the underlying position's size is usually smaller compared to that of a futures contract.

How to Make Gains

- Consider this position as a great opportunity to hedge
- Exercise the option as soon as it is deep in-the-money
- Hold your position until it expires then benefit from the size of increase between strike price and asset price

10. ES Weekly Options

This type of options contract is commonly referred to as weekly options on futures. It is mostly used by day traders for short-term swing trading as well as day trading. The weekly options on futures provide an additional day trading opportunity with even more benefits. Here is a look at these benefits;

- These options expose you to limited risks
- You do not need to have a futures account in order to deal in them
- Common rules such as pattern day trading are not applicable in this case
- Options increase in value much faster when you go long due to the option Greek

Even then, there are some cons or negatives related to this trading type. Here is a look at some of these negatives;

- They have a very brief time period before expiration
- You need a lot more effort in order to place
- It is challenging to set limit orders if you're expecting to enter or have a target

Just as it is with futures trading, when trading the ES Weekly Options as a day trader on the 15-minute charts, you get access to more valuable intraday opportunities in relation to the daily chart.

11. E-Mini Options

One of the least known options contracts is the E-mini contract. This is an option that is electronically traded. It is viewed largely as mini version of the ordinary futures contract. The E-mini contract, just like with other mini options, is in line with the structure of the standard counterpart just smaller in size and cheaper in price.

These contracts offer investors great leverage especially when investments are relatively small. The only challenge is that any potential losses are exponentially large. While these E-mini contracts were first made available for the S&P 500, they are today readily accessible on other indices such as the S&P Midcap 400 and the NASDAQ 100.

These options are sometimes used by day traders to hedge or even as a leveraging tool. Traders and investors can also use E-mini options to increase their profits on other future trades. They are also popularly used to protect or safeguard a position that is perceived to be vulnerable to market movements.

12. ETF Options

An ETF options is an options contract that is derived from the ETF or exchange traded fund. ETFs are basically investment pools that are then traded at the stock market. Electronically traded funds contain a specific number of underlying assets that include bonds, commodities, and stocks. They trade very near to the net asset value throughout the course of the trading day.

The shares and other financial instruments are traded in much the same manner as regular stocks at the bourse. This way, a trader is easily able to purchase and sell shares and even options of an electronically traded fund via a brokerage account. You will find ETFs across all the common stock indexes such as the Nasdaq 100 composite (QQQQ) and the Dow Jones Industrial Average. Sometime traders will choose a specific industry because chances are high of finding stocks of major industries across most ETFs. This way, traders are able to focus more on determining and predicting

movements in a specific industry rather than a mixed choice of stocks as offered by standard index ETFs.

ETF options come in very handy as their related options trade throughout the day. As a day trader, if you actively trade ETF options and make use of hedging strategies, then you need to ensure that you are well informed regarding the background information of the underlying stock. If you feel confident about this information then you will gain from the tax breaks and low costs associated with trading ETF options.

13. IRA or Individual Retirement Accounts Options

Yet another options account that is out there is the IRA options contract. However, IRA accounts are generally unavailable to the general population because of rules put in place by the SEC or US Securities and Exchange Commission.

The SEC demands that any day trader have the appropriate designation and should hold margin brokerage accounts. However, this is not the case when it comes to an IRA account. Such accounts cannot be margin accounts and are limited to only cash accounts.

In simple terms, day trading of stock options and stocks needs traders to operate a margin account and any IRA account used should have only a cash account status. The only alternative that you can have is to create your own IRA account via a commodity futures broker.

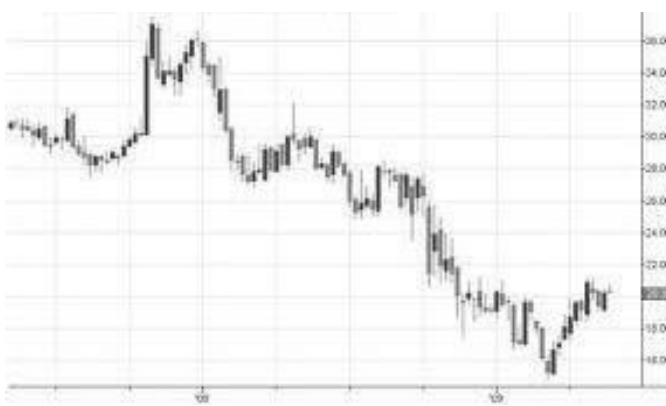
Chapter 4:
Managing Options Positions

Risk Management with Options

A lot of investors are of the opinion that trading options is a lot riskier compared to stocks. This can largely be attributed to their lack of understanding of the leverage concept. When applied correctly, options can be just like other securities and not quite as risky. Fortunately, there are ways of working out risks and determining the potential of risk when trading options. It is also a good idea to learn about the power of leverage.

A Trading Plan

As a trader, it is absolutely essential that you come up with a suitable trading plan. Such a plan should be sufficiently detailed and should contain certain parameters and guidelines that outline trading activities. A good plan needs to include detailed information regarding levels of risk that you are willing to take. The plan should also showcase the amount of capital readily available to you.



The idea of using a plan is to ensure that your trades are planned appropriately and that you only trade wisely as you had envisioned. Trading options should not be a gamble, guesswork, or some random trial and error game. Instead it should be a well-thought-out process with specific funds allocated to specific trades. This way, you will easily avoid most of the mistakes made by those who consider trading options as risky.

Also, when you trade with funds that you cannot afford to lose, then you will be extremely careful about your trading habits. This is one of the ways of limiting risks and introducing discipline to trade. Also, traders who follow a trading plan and stick by it are likely to make informed decisions and will not trade using “scared money.”

Getting Rid of Emotion

Traders agree that it is not easy to completely get rid of fear and emotion when trading. However, focus is more important. A focused trader with sufficient experience and with a sound trading plan is likely to fare better than a trader with neither experience nor trading plan.

Experienced traders are aware that emotions can lead to the downfall of a trader. Once emotions take over, a trader will toss their trading plan out of the window and start to either recover money that’s lost or delay exit from otherwise mature positions. Therefore, greed and fear are the main culprits in this case.

Discipline is the key to successful trading. Traders who focus on studying the markets, conducting technical or fundamental analysis then coming up with a suitable trading plan are bound to be more successful than those who let emotions take charge. Emotions will cause a trade to act irrationally and they will keep throwing good money after bad money. Emotions cause trader to not exit their positions when they have to especially loss-making positions. They believe that a trade will turn around soon and they will recover their lost funds. As such, they keep losing more and more money. Others refuse to exit a winning trade and hang in there risking even the amounts earned. At best traders should exit a winning position, collect profits and then re-enter the trade.

Leverage

One of the best ways of managing risks when trading options is through use of leverage. Leverage can be defined as the use of an amount of money to trade at the markets with a significantly larger position that the traditional approach would allow. This is exactly what options traders seek to achieve.

For instance, an option trader with $10,000 is able to control a much larger stake than a stock trader. This is because an options

contract may control about 100 shares at a cost of only $1 per contract while a stock trader will have to pay the full value of the stocks. This is what leverage does. It gives you a huge advantage and enables you to make significantly large profits.

Leverage can also mean controlling a similar stake in the position as a regular stock trader but spending a significantly smaller amount of money. This provides an excellent way for small traders with limited trade capital to invest in the markets with potential for large profits. A trader's appetite for risk will often determine the kind of trades they enter and amount of funds committed to each trade. Traders should make use of leverage as often as possible if they are to increase their profits exponentially.

Options Contracts

Investors have plenty of financial and strategic leeway with options compared to simply investing in stocks. By investing in options, traders not only hedge to protect against losses but also gain access to stocks at a fraction of the normal costs. Options contracts lower your risk in all market conditions on speculative bets and increase your profits on any new or existing positions you may take.

Trading in options has a lot of positives compared to trading in stocks only or other securities. However, there are some inherent risks that you need to be aware of. As a potential trader, you need to be aware of the great benefits as well as inherent risks relating to trading options.

Pros of Trading Options

1. You require much lower upfront financial resources than with stocks

The cost of buying options, which includes the premium amount and trading commission, is much lower compared to the amount you will pay to invest directly in shares.

As an investor or trader, you will pay far less money to invest in the same number of shares compared to one who invests directly in shares. However, if the trade is successful, then you will benefit just as much as a direct investor percentage-wise.

2. Limited losses when you invest in stocks and options

When you purchase stock options, you are not required to exercise your right to buy or sell the underlying stock. If your estimations or speculation about stock movement are right, then you make a large profit. However, should your speculations not follow through, then your losses are limited only to the cost of the premium and brokerage fees.

3. Options offer traders flexibility on their trades

There are a couple of strategies that can be implemented by investors or traders before expiry of the contract. Here are some of these strategies;

- You can exercise an option and purchase the underlying stocks then add these to the portfolio
- You can also exercise an option contract, purchase shares and then sell them for a profit at the stock market
- You can make back some funds that were spent buying an out-of-the money option. this is by selling the option to another trader before it expires
- You can also exercise options that are in-the-money to other investors

4. Options can help you to fix the stock price

Option contracts act similar to lay-away in stores because they let investors fix the price of a stock at a specific value which in our case is the strike price for a couple of days, weeks, or months. This guarantees you that an investor will be able to sell or purchase the underlying security at the strike price before the option expires.

5. You have plenty of leverage

Using options contracts, you are able to invest a significantly tiny amount of money yet control a large amount of shares. For instance, a single options contract enables you to be part of the movement of 100 shares of a stock. In this case, you risk will be limited to a certain level and the costs will be extremely low.

Setbacks of Trading Options

1. Sellers are exposed to large and sometimes unlimited losses

Option buyers and holders are only exposed to small losses.

However, the option writer's risk is almost unlimited. The losses that they stand to incur are so much greater than the cost of the options contract. The reason is that they have obligations of purchasing or selling stocks or the underlying stocks if a buyer or seller chooses to exercise their right.

2. Time is always limited for the investor to make profit

Options are short term in nature. Investors who use options often seek short-term or near-term price movements that they can capitalize on. These price movements need to take place within a matter of a couple of days, weeks, or months for the payoff to happen.

As such, it is crucial to make a number of assumptions. These are deciding when to buy an option and when to exercise it or walk away from the contract before expiration. This contrasts long term stock buyers who have really no time limit. They are able to invest and wait for years and even decades.

3. Traders have to qualify to trade

As an options trader, there are certain essential criteria that you must meet if you are to start trading. For instance, you must be approved by a broker. You do this by answering a couple of questions or going through a similar screening process. The broker will need to find out about your personal financial situation and your knowledge and experience with risk and understanding how to trade options.

After the screening, then you will most likely be assigned a trading level based on your skill and experience. The broker will also take into consideration your understanding of risk posed by options trading. This level will dictate the kind of options trades that you will be allowed to place.

As a trader, you will generally be expected to maintain a minimum balance of roughly $2,000 in the brokerage account. This is the general requirement within the industry and this is a cost that you need to seriously consider.

4. Options traders can incur added costs that affect returns

There are certain strategies that need you to set up a margin

account. For instance, when selling a call option contract on securities that you do not own. This margin account provides a line of credit that is held as collateral in the event the trade moves against you.

There are different minimum requirements across the various brokerage firms for account opening and so on. The interest rate and amount will depend on factors such as how many securities and cash are present in an account. You can get access to margin loans with interest rates ranging from the low single digits to the low double digits.

In the event that you are unable to repay the margin loan advanced to you by your brokerage firm, then the broker will issue a margin call then liquidate your account should you not add some funds or securities to it. This can also happen if your account falls below a certain percentage which is very possible in the course of a trading day.

You can learn detailed information about the risks and characteristics of standardized options contracts at the Options Clearing Corporation of the USA. There are also income tax regulations that you need to familiarize yourself with if you are going to trade in options and other securities.

Pros of Trading Equities

1. Equities have Significantly High Liquidity

Compared to options markets, equity markets are significantly more liquid. For most traders and investors, it is easy to enter and exit positions. This can happen within minutes in most cases. Exiting positions within a matter of a few minutes is especially easy for stocks that constitute major indexes such as the S&P 500. This liquidity often comes from mutual funds and passive index funds that are invested in the S&P 500 stocks. These funds are regularly seeking to invest in stocks contained in the fund in order to own larger percentages.

2. Time is on your side

Options give you very little time to profit from market movements. This is not the case when it comes to stocks. In fact, stocks have no

time limit which means you can hold them for as long as you see necessary.

As a stock investor, you have plenty of time within which you can enter and exit trades. You will not be punished for early or late entry into trades. However, options traders really need to factor in time because options contracts are limited by time.

3. Stocks generally have lower risk

Both stocks and options have their own pros and cons. However, in general, traders and investors view stocks as being generally less risky. The volatility of any given stock is generally much lower than that of options. Also, stocks have no risks due to time decay.

Disadvantages Associated with Stocks

There are certain downsides of equities trade compared to options contracts. We will examine some of these disadvantages and see how they compare to options.

1. Stocks have limited upside

Most stocks move in tandem with respective indexes. Stocks rarely move above 20% in any given year. Traders with limited finances or small capital will be frustrated to discover that even with all the time in the world, their income potential is limited. This contrasts traders who focus on other instruments such as options who are able to double their income in just a few short months or even weeks. Just a few well managed options trade and good risk management techniques, it is very possible to multiple investments within a short time period.

2. Stocks have limited leverage

Investors in stocks can only access limited capital through borrowing of only up to 50% of the total value of securities they have purchased. This refers to margin loans that are advanced by brokerage firms to clients.

This limitation is placed by the federal government through the Federal Reserve's regulation T. This regulation applies only to equities markets but not the derivatives markets. The use of excessive leverage is discouraged and generally frowned upon.

However, investors with capital amounts totaling about $5,000 can access marginal loans of up to $10,000 which they can use to invest in trades.

3. Higher risks for lower profits

It is possible to put money in a stock and actually lose the entire amount. While this is very rare and hardly occurs, it can happen should the asset's value tumble down to zero. When it comes to options, you only stand to lose your initial investment only which in most cases is the premium paid for the options contract. While the losses may sound similar in both cases, this is not so. The amount of capital needed to invest in stocks is vastly different from amounts used in options trading.

Example

Let us take stock ABC which is currently trading at $100. According to your estimates, this stock will rise by $20 to about $120. As a trader, you decide to purchase 100 shares so that you make a profit of $2,000. To achieve this, you will have to invest $10,000 and put it at risk.

With options, you will only need to invest about ($1.50 * 100 = $150). You will only spend $150 which is the amount that you need but still make as much profit as the stock investor.

Other Important Considerations

In order to make informed decisions about whether to buy, sell, or hold stocks, you need to understand more about a company's operations and business. You also need to understand the company's vision and have a sense of direction that the asset is heading. This is crucial especially for options traders.

To be successful, options investors should have excellent understanding of a company's intrinsic value and also affirm thesis regarding the foundations of a business and how near term events will affect its performance such as macroeconomics. Numerous investors can choose to think options just add complexity to their basket of investments.

However if you really want to earn big profits and enjoy attractive returns on your investments, then options trading and investments

is really the way to go. It is crucial that you learn how to trade options and how to limit your downsides. Fortunately, these are some of the things that you will learn in this book.

Choosing Options over Stocks

Leverage

When you buy options, your potential gains are virtually unlimited while any potential losses are limited to your original investment and any additional costs incurred such as the brokerage fees. Therefore, in theory, your potential gains are limitless while losses are capped to the amount paid as premium.

Also, you spend significantly less to invest in stocks through options compared to direct stocks investments. For instance, to buy $10,000 worth of stocks, you will need to fork at least that much money. With options, you will pay a tiny fraction of this amount. However, you stand to gain the same returns in both cases.

Example

Assume that you have $10,000 to invest at the stock market. Take a look at stock ABC which is worth $20 per share. With $10,000, you can buy 500 shares of the stock. If you were to put this money on options, you'd control a much larger share amount because options cost significantly less.

At $2 per contract, it would cost you $200 per options contract with 100 shares per contract. Our investment amount of $10,000 would easily fetch us 50 options contracts with over 5000 shares. A small movement in the right direction would earn you a significantly high profit compared to buying stocks.

Fine-tuning Strategies

When you invest your funds in shares, your options are pretty much limited to buying or selling shares. However, with options, it is easy to identify a strategy that does fit your expectations. Stock options can be purchased and exercised in numerous combinations that enable traders to fine-tune strategies so that they can match market conditions whether bearish, bullish, neutral or in-between.

For example, as an options investor, you can opt to select a variety

of expiration dates. These can range between about-to-expire monthly options with LEAPS that have close to three years before expiration. It is possible to find a strike that is based on both your risk tolerance and stock performance expectation.

With this approach, you are also able to benefit significantly from high market volatility simply by choosing a strategy that will benefit you from major movements in either direction like the short straddle. Options are also widely used for hedging positions such as the protective put and for managing risk such as with the stock replacement strategy.

Risk Management with Options Spreads

Another powerful tool available to options traders is options spread. The term options spread refers to the situation where a trader combines two or more options contract positions which are based on the same underlying asset. This is done in order to come up with a single trading position.

All strategies relating to options use spreads. Spreads provide an excellent way of managing risks when it comes to trading options. They can be used by traders to minimize upfront costs of entering a trade and to reduce the total amount that can be lost should a trade not work out. While this may affect your profitability, it also reduces the risks that you face in a trade.

Spreads are also used by traders to minimize the risks inherent anytime they enter short positions. For instance, if you are trading options, then you could probably be exposed to possible losses should the underlying stocks lose value. Also, if you had purchased some low cost puts, then you probably would have to incur additional costs in the process.

It is very possible and actually easy to manage risk using options spreads. There is a big range available to traders. These can be utilized to benefit a trader in the market regardless of conditions.

Diversification and Risk Management

Another popular risk management technique adapted by options traders among other traders is diversification. Diversification is a process that typically involves the purchase of different assets and

building a portfolio so that it contains assets from different classes.

Diversification has a basic principle that focuses on spreading risks across different investments include stocks, bonds, shares, options, and so on. This principle states that spreading out investments and diversifying into different asset classes develops a balanced portfolio. This way, risks are minimized. Rather than focus on one or two securities, traders need to focus on a wide variety of stocks. This approach has been proven time and time again to be the most effective management tool for both investors and traders.

Also, a portfolio that is suitable diversified is considered as least exposed to a variety of risks compared to non-diversified portfolios. Options diversification is a little bit different however. It doesn't work the same way as regular diversification. The principle is largely the same and there is no need of investing too much funds in a single trade. Diversification implies trading in a variety of options strategies. This way, you will most likely have some strategies that work out and hence profitable. This is much better than putting all funds on one strategy which may or may not be successful in the end.

Calculating Risk

There is a standard method that is globally accepted by traders for risk calculation. Instead of buying stocks directly using a fixed amount of money, it is much easier to purchase a call option at a much cheaper price and still gain control of the same number of shares. The saved amount can then be invested or spent on other strategies.

For instance, instead of spending $10,000 to purchase 400 shares of ABC stock at $25 per share, we can buy call options and spend perhaps $400 and still control 400 shares of ABC stock. This represents a total savings of $9600 which is a pretty significant amount. The saved amount can then be spent in different ways. For instance, it can be used to buy more options or invested in additional stocks or other securities.

If you think about it, you will be earning a profit, or dividend, on a stock that may not be paying others. This is not only a benefit to you but also a superb risk management technique.

You also need to learn how to balance the disparity between cost and size. Basically, there is a huge difference between $10,000 worth of stocks and $10,000 worth of options. The options carry a much larger risk compared to the stocks. This should be mitigated in order to reduce the risk. The best approach in this case is to acquire an option position risk-equivalent related to the stock position.

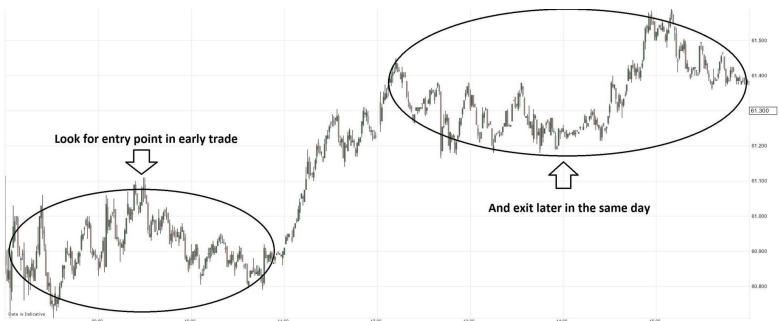
Main Advantage of Options

One of the biggest advantages of trading in options is that traders are able to benefit immensely in the price movement of a stock without actually having to buy the stock. For instance, if stock ABC costs $25 per share and you believe that this price will go up in the next three months, then you will spend $2,500 to buy 100 shares. Alternatively, you could buy a call option with a $27 strike price that has an expiry date of 2 months. This will cost you a mere $50 is a single option costs $0.5. This is because $0.5 X 100 = $50.

Chapter 5:
Advanced Options Trading

Now that you understand a little more about options, it is time to get ready to learn some advanced techniques. First, let us recap a few of the basic concepts. An option is simply a contract that awards you the right to buy an underlying security but does not obligate you to do so.

A single options contract represents 100 shares of a specific stock. The contract provides an expiry date as well as an agreed price. As a trader, just as you buy a stock because you believe its price will go up, you can take the same approach with options. Options will let you wager on the direction that you think the stock will move.



However, remember that buying an option implies entering into a contract. This contract dictates a number of things that you can do. For instance, you are allowed to;

- Buy shares of a stock at an agreed price within a pre-defined period of time
- Sell the options contract to another investor
- Allow the options contract to expire

Advanced Options Trading Strategies

Getting Started

In order to buy and sell stock options, you will require the services of a broker. Brokers provide you access to a platform where you will find all kinds of financial securities including options contracts. You need to know how to identify a broker that is suitable for your needs. It is also advisable that you are actually able to open a

trading account with your broker.

Vetting

Before you get started, you will need to clear a couple of hurdles. Trading options is considered complex compared to trading stocks and bonds. The amount of capital required to trade is considerable. This is why brokers wish to learn a little more about you, your financial status, trading profile, and experience.

The broker will interrogate you and put you though a vetting process before eventually allowing you to start trading. Brokers will then allow you to place trades on their platforms. A broker will require certain specific information from you. For instance, a broker will want to know about;

- Your investment ambitions and objectives like growth, income, capital
- Your trading experience such as your knowledge about investing, you experience regarding stocks and options trading and the number and size of your trades.
- Your personal financial information such as your annual income, your net worth, employment details, and other sources of information
- The type of options strategies you are interested in and the options that you wish to trade

After you provide your answers and the broker is able to assess you, he or she will then award you a trading level. The initial trading level, which ranges from 1 to 4, will indicate the point at which you will begin.

Two-Way Screening

You need to know that screening should be both ways. Even as you get screened by a broker, you will need to screen them as well. Your broker will be your most crucial partner from this point on so you need to ensure that you will have a positive relationship together.

An appropriate broker is one with the necessary research and trading tools and will provide the necessary customer service, guidance, and support. This is especially important for first time traders who are new to options trading. You need to also compare

and contrast other traders and see who offers you the best platform, tools, and support. This is easier nowadays because most of them have been rated by traders.

Diagonal Options Spreads

It is now time to examine diagonal spreads and how they can be applied to different strategies. Keep in mind the fact that options spreads can be either credit or debit spreads, and are easily created using call and put options. However, there is a variation when it comes to the diagonal spread.

In the case of diagonal spreads, we focus on the time spread along the horizontal time spread so as to move the longer of the legs to another strike. When you choose a back month leg, this is known as diagonal spread. The back month leg should be different from the front month leg.

1. Diagonal Spread with Calls

The diagonal spread with call options is also known as the diagonal bull call spread. This strategy consists of simultaneously purchasing long term call options as well as writing a similar number of call options. The call options are near-month with a higher strike price but the same underlying stock.

You would use this options strategy when you are neutral or slightly bullish about a stock in the near term and quite bullish in the long term. As such, when you are putting the strategy together, you will buy one long term in-the-money call option and then sell 1 near term on-the-money call option.

The Strategy

It is easier to think of this strategy as a two-step process. The diagonal spread strategy with call options is basically a cross between a short call spread and a long calendar spread option with some calls.

However, this strategy consists of only two similar strike combinations. These need to be similar in order to work as desired. In this situation, it is the differential theta that is at work. This is true in both diagonals and horizontals. However, it is possible to come up with an out-of-the-money horizontal spread.

Profits on the Upside are Limited

When dealing the diagonal spread with call options, then your best scenario is the instance where the price of the underlying stock remains unchanged but rises above the strike price of the call option that is sold off at the time that the call expires.

When implementing this strategy, it is important that a trader writes another call and repeats the entire process each month once the near-month call option expires. This repetition should continue each month until when the long term call option expires so as to minimize the cost of the trade. In some cases, the costs may come down so much that it becomes a free process.

Under a perfect scenario, the maximum possible profitability is scenario is a situation where all the profits or premiums obtained from the sale of call options as well as the difference between the strike price of the different call options less the cash obtained as debt to initiate the trade.

On the other hand, we can have a downside but in this case, any loss or downside is generally limited. As such the largest possible loss when this strategy is applied will be limited to only any debt that is taken to initiate the position. Such a situation will arise should the price of the underlying stock decrease and remain down until such a time as when the call option (long-term) expires.

Tips and Advice

There are certain benefits that can be accrued when applying or implementing this position. For instance, when the diagonal spread with calls is used for credit spread, then there will be potential profits in the long back month option. the Vega short can easily turn into the Vega long.

As an example, this position can begin as slightly Vega short position or perhaps even a neutral one. Vega short position is possible when creating a credit. However, in the nearby position, the time value may begin to decay and as such the Vega position changes from short to long.

This scenario functions almost perfectly when put options are utilized to create the spreads. Should the stock price drop any

lower, then the rise in the value of implied volatility will be captured by the long option. Implied volatility often goes hand in hand with fears of a drop in the surrounding stock's value.

Reversal of the Position

Sometimes diagonals are reversed. Now when this happens then the spread will undergo a turn or flip in the same way that reversed horizontal spreads do. They flip back to the short Vega from the long one. This happens when there is a loss incurred due to volatility rise.

Under a perfect scenario, the maximum possible profitability is scenario is a situation where all the profits or premiums obtained from the sale of call options as well as the difference between the strike price of the different call options less the cash obtained as debt to initiate the trade.

Generally, these trades possess an exact image of potential success and profitability. The trades should be created under the impression that a profit can be generated from a very brief and fast change in volatility as the chances of huge movements of the price of the underlying stocks is almost zero.

In Summary

The diagonal spread with call options is also known as the diagonal bull call spread. This strategy consists of simultaneously purchasing long term call options as well as writing a similar number of call options. The call options are near-month with a higher strike price but the same underlying stock.

You would use this options strategy when you are neutral or slightly bullish about a stock in the near term and quite bullish in the long term. As such, when you are putting the strategy together, you will buy one long term in-the-money call option and then sell 1 near term on-the-money call option.

2. Diagonal Spreads with Puts

We have already noted that diagonal spreads constitute an options trading spread strategy with both sale and purchase of same number of options, similar underlying securities, and also within the same class. However, they have varying expiration dates and

strike prices.

The diagonal spread and the calendar spread are very similar. Under the diagonal spread, we buy long-term options and at the same time sell near-term stock options. It is also extremely similar in nature to the calendar spread because long term options are purchased while short term options are sold. This enables traders to benefit from the fast time decay employed by this strategy because options are almost about to expire.

The one major contrasting feature between diagonal spreads and calendar spreads is only the near-term outlook. Both are near-term but the diagonal spread's outlook is a little more bearish or bullish.

The Diagonal Spread with Calls

If you are an options trader with a bullish outlook on a certain stock, then you can initiate this strategy. Implement the diagonal spread using calls by writing call options that are near-month and with a high strike price as well as call options that are far-month with a lower strike price.

Diagonal put Spreads

In this case, if your outlook in the near term is sort of bearish, then you should implement this strategy. If you do, then you will be required to write put options with a higher strike price and a far month outlook against put options with a lower strike price and a near month outlook.

The Strategy

The diagonal spread strategy with put options is basically a dual step strategy includes elements of a short spread put options as well as a long calendar spread with put options. This strategy basically starts out like a play with time decay and proceeds to morph after an additional put is sold at strike price B. In this instance, it is said that you have entered or legged into a short put option spread. Basically, as the trader, you will easily set up this strategy if you want a small net debit or even a net credit.

Tips and Advice

Whenever you implement this strategy, you need to ensure that there is some volatility in the market. You also need to have some predictability with the volatility. The reason for this is that some volatility is acceptable because it is our hope to sell the two options and earn as much from the sale as possible. Even then, it is crucial that our stocks remain as stable as possible. This is sort of contradictory and hence the need for this strategy to only be implemented by a seasoned trader. A good trader will know exactly how to manage the trades and also how to implement risk management techniques.

How to Set Up the Strategy

Start out by selling a put option that is out-of-the-money at strike price B. Ensure that it is a front-month with near term expiration. Next you will buy a put option that is out-of-the-man with a strike price A as well as back-month expiration date that is a month away. Once the front month attains expiration then you should sell a put option at the strike B price. This option should have a similar expiration date as the put option with a month later expiration. In general, the price of the stock should ideally be high than strike B price.

This is a strategy that should only be managed or implemented by a seasoned intermediate or advanced trader. This is because you need a deeper understanding as well as experience implementing this strategy because it involves options that have varying expiration dates.

This specific strategy should only be implemented when the trader thinks there will be plenty of neutral activity in the course of the front month followed by more neutral or even bullish movement on the markets in the option's back month.

You will break-even at expiration if your approximation is accurate. However, this can be difficult to predict basically because of too many variables involved. The strategy actually has more than one expiration date on this diagonal spread. As such, you will need to come up with a pricing model that will estimate what variables are in play and what possible outcomes are.

Profit and Loss

When you apply this strategy correctly as required, you will receive maximum profit based on the met credit that you obtain after selling your put options at the strike price B and then deducting any costs incurred when buying put option with strike price A.

Calculating the exact profit when using this strategy can be tricky as this will depend on factors that are yet to occur such as the premium received from the sale of the put option which occurs at a later date.

You can also incur a loss when you apply this method. Basically when you set up this strategy for purposes of net credit, then any possible risks will be limited to strike price A less strike price B less the net credit obtained. However, when the strategy is set up for purposes of a net debit, then your risk will be limited to the difference between the two strike prices added to the net debit paid.

Time Decay

At the onset of this strategy, time decay will be favorable to you. This is because any short-term put option will suffer losses in time value at a much quicker rate compared to long-term options.

Implied Volatility

Once you establish this diagonal put options spread, you will be in a better position when the implied volatility value goes up significantly especially towards the expiration dates of the front month. Once the front month expiration is over, your strategy will have put in a leg in a short put spread. The effect of implied volatility will mostly rely on the position of the stock based to the strike prices.

3. Long Butterfly with Calls

The main purpose of this advanced technique is to make money from using short calls for price action that is close to the strike price with minimal risk. Therefore, this technique should be reserved for expert traders with some experience. Novice traders should not try this technique because of the high risk involved.

Definition

The long call butterfly is a strategy that with earn you a profit

should the underlying stock at expiration be within the body of the butterfly. This strategy makes use of two shirt call options each at a middle strike as well as a long call option at an upper strike price and another at a lower strike price. These three create what is known as the long call butterfly.

Three-Part Strategy

A long butterfly spread with calls is essentially a strategy consisting of three distinct components. You create this strategy by first purchasing a single call options contract, whose strike price is lower, then buy another call option with an even larger strike price, and finally sell two call options that have a higher strike price. All these call options have similar expiration dates and with equidistant strike prices.

A trader will establish this strategy to get a net benefit where both the maximum risk and maximum benefits are limited. As a trader applying this strategy, you will receive the maximum benefit anytime the stock price and strike price of the short calls are equal upon expiry. However, the maximum risk includes the total cost of setting up the strategy and this includes costs such as commissions that have to be paid. The loss will occur when the stock price is lower than the lowest strike price or higher than the highest strike price upon expiration.

The Strategy

As noted above the long butterfly spread with call option is an advanced strategy that requires careful planning, market analysis, and a seasoned trader. Basically, the profit potential of this strategy is considered tiny when viewed in terms of dollars as costs incurred are steep. Keep in mind that this strategy involves a number of commissions as well as multiple payments for the different strike prices. Also there are three bid-ask spreads during the time of opening and closing a position.

In this case, it is important to ensure that the prices are as affordable or attractive as possible. Low prices will help to maximize on profitability. Therefore, as a trader, you should focus on opening and closing on what is considered as good prices. This way, you will be able to comfortably manage the risk/reward ratio

that also includes commissions.

This long call butterfly position combines a short call spread with a long call spread where the spreads trend towards and eventually meet at strike price B.

In an ideal situation, you will benefit greatly when call options with the strike price B and strike price C to expire worthless. Even as they expire, they should possess the intrinsic value of the call options that is in-the-money at price A.

When you apply this strategy, you will be selling at strike price B two option calls. This makes butterfly strategies relatively low cost strategies to implement. For this reasons, traders may get tempted to implement the strategy. However, the risks are a little higher because chances of success are pretty slim.

To make this a successful strategy, you should create it such that the strike price B is either a little in the money or a little out of the money so as to make it less costly to operate. This approach will also introduce a bias on the direction of the trade. For instance, should strike price be larger than the prevailing stock price then the trade is considered bullish. On the other hand, should strike price B be lower than the prevailing stock price, then

The set up

To create a perfect setup, first purchase a call option at strike price A. Once this is done, you will then sell two call options as strike B price. Finally you will then purchase a call option at strike price C. In this instance, the stocks are at the strike price B. Also, all options expire within the same month and the strike prices are generally equidistant.

Maximum Profitability

When you apply this strategy, you can expect to attain maximum profitability under certain conditions. This maximum profitability is equal to the difference of the middle and lowest strike prices minus the cost of setting up the position as well as all commissions. These kinds of profits are realized anytime the price of the stock is equal to the short calls strike price upon expiration.

The Total Risk Possible

As a trader it is important to understand the kind of risk that you are exposed to. In this set up, the size of total risk possible is equal to the net cost of setting of setting up the strategy as well as all commissions. In such cases, there are not one but two possible results that can lead to maximum loss.

First of all, should the stock price at expiration be below the least of the strike prices then the calls will collectively expire and be completely worthless. You will lose all money including all costs incurred in setting up the strategy and the commissions.

Also, should the price of the stock at expiration be more than the highest strike price, it will mean all call options are in the money. As such, the long butterfly spread strategy at expiration will have a zero net value. This way, the total cost of setting up the strategy and all commissions paid are lost.

Tips and Advice

Sometimes traders prefer to implement this strategy with index options instead of individual stocks or even options. The reason for this is because in the past indexes were not known to be as volatile as stocks. Also, when an index fluctuates, it will be cancelled out by another which has the tendency to reduce the volatility of the entire index.

4. Long Butterfly with Puts

The long butterfly spread strategy is in essence an options strategy with limited risk. Traders adapt this strategy when they are of the opinion that the underlying stock is not going to rise by much at expiration of the trade. The main goal of this strategy is to profit the trader or investor with limited risks from stock price action that is close to the stroke price of the short puts.

This long butterfly strategy is basically a three-component strategy which is designed by first purchasing a put option at a high strike price then selling two put options that have a lower strike price before finally investing in a put that has a lower strike price.

As such, we can say that the long butterfly put option strategy has 3 striking prices which are known as strike price A, strike price B, and strike price C. you will construct this strategy through purchasing writing two put options that are at-the-money, then buying a put

option at a lower strike price before finally purchasing another option.

Construction

This long butterfly put options strategy is a limited risk and limited profit strategy. Traders implement this strategy when they are of the opinion that the price of the underlying stock will not rise or fall significantly upon expiration.

To construct this long butterfly put option strategy, you first need to purchase 1 out of the money put option then sell 2 at the money puts before eventually buying one in the money put option.

From the construction above, you will note that there are three distinct strike prices in this long butterfly put option strategy. You construct it through the purchase of the put option with a lower strike price A, then write two put options that are at the money before eventually getting the put option that is in the money.

An Advanced Strategy

The long butterfly put option spread is an advanced options trading strategy that should be left to advanced traders with sufficient experience. For instance, the strategy has three bid-ask spreads, three prevalent strike prices together with multiple commissions. Therefore, it is advisable to be cautious and find good prices for the options opening and closing positions. Also ensure that the risk to reward ratio is sufficient so that even after paying off commissions, the rewards are sufficient.

Limited Profits

As a trader, you will be exposed to limited profits when implementing this strategy. In the same way, you will enjoy maximum profit when the price of the underlying stock is unchanged upon expiration. Basically, it is at this price that the put option will prevail and expire in the money.

Basically, maximum profits will be obtained when we subtract the net premium paid, strike price of the short put option and commissions paid from the strike price of the higher long put option. Essentially, you will achieve maximum profit when the strike price of the short put is equal to the price of the underlying

stock.

This long butterfly strategy is basically a three-component strategy which is designed by first purchasing a put option at a high strike price then selling two put options that have a lower strike price before finally investing in a put that has a lower strike price.

Greatest Profitability

In this instance it is important to note how you acquire the maximum possible profits. This only happens when profits are equal to center strike price and highest price minus the cost of setting up the strategy including all the commission. You will basically achieve maximum profitability when the stock price and strike price of the short puts are equal when the puts expire.

Maximum Risk Possible

When you execute the long butterfly strategy with puts, your highest possible risk including commissions that you have to pay can be one of two outcomes. One possible outcome is when the price of the underlying stock is greater than the biggest strike price when the option expires. At this juncture, the put options will expire worthless. This includes all the associated costs such as setting up the strategy, commissions to be paid and so on.

The second situation is when, at expiration, the price of the stock is lower than the strike price. At this juncture the butterfly position will have a zero net value and all the put options will be in the money. With this situation, you will lose the entire position including all the costs incurred and commission paid.

Appropriate Market Forecast

This long butterfly spread with put options enjoys best profitability scenario when center strike price is equal to the stock price when the options expire. As such, the best forecast scenario in this instance is when the stocks are slightly bearish or simply neutral. This, though, depends on the relationship of the center strike price with the stock price when the position is established.

The long butterfly put option spread is an advanced options trading strategy that should be left to advanced traders with sufficient experience. For instance, the strategy has three bid-ask spreads,

three prevalent strike prices together with multiple commissions. Therefore, it is advisable to be cautious and find good prices for the options opening and closing positions. Also ensure that the risk to reward ratio is sufficient so that even after paying off commissions, the rewards are sufficient.

This long butterfly strategy is basically a three-component strategy which is designed by first purchasing a put option at a high strike price then selling two put options that have a lower strike price before finally investing in a put that has a lower strike price.

As such, we can say that the long butterfly put option strategy has 3 striking prices which are known as strike price A, strike price B, and strike price C. you will construct this strategy through purchasing writing two put options that are at-the-money, then buying a put option at a lower strike price before finally purchasing another option.

5. Iron Butterfly Strategy

The iron butterfly option strategy is part of a group of strategies referred to as wingspreads. These strategies earn their name from the fact that each is named either after a condor or a butterfly.

This specific strategy is created by putting together a bull put option spread and a bear call option spread with similar expiration times and these meet together at a strike price. The body of the butterfly in this strategy is formed by a put option and a short call option which are sold at the cost of the middle strike price. These converge at the middle. Then we have a put option and a call option as the middle or central strike price. These constitute the butterfly's body. To complete the strategy, we buy put options and call options that are either below or above the median strike price. These form the butterfly's wings.

It is evident that this is a complex strategy that should be implemented only by a seasoned trader. It differs from the other butterfly strategy in two ways. For instance, it makes use of four distinct options contracts and not three like the basic butterfly spread. Also, the investor receives a net premium from this credit spread strategy compared to the ordinary butterfly which happens to be a debit spread.

This four part strategy has both a bull call spread and a bear put spread both of which share a similar strike price. All the options expire at the same time or on similar dates. The strike prices are equally spaced from each other. We establish this specific options strategy in order to gain a net debit. The profit and loss margins are limited.

You will enjoy the highest possible profitability when the price of the stock at expiration is lower than the lowest strike price or higher than the highest strike price. On the other hand, highest possible risk will occur when the price of the underlying stock is the same at expiration as the long options' strike price.

Applying the Iron Butterfly Strategy

This strategy has limitations in both losses and profitability. Traders use this strategy and other iron butterfly strategies so that traders are able to withhold some of the premium that is paid by options buyers. This situation occurs when the underlying stock's price us between the two strike prices at expiry. These are the lower and upper strike prices.

Traders and investors at the markets apply this options strategy when they are of the opinion that the underlying stocks will finish in between the two strike prices at expiration. Higher profits are possible depending on how close the underlying stock is to the middle strike price at the time of expiration. Basically, higher profits will accrue the closer the middle strike price the underlying stock gets.

Losses are likely should the price of the underlying stock be somewhere below the lower put option's strike price of above the upper call option's strike price. However, there is a breakeven point which can provide some relief to traders. This position is arrived at by subtracting and adding the premium paid from the median strike price.

Tips and Advice

Basically, the strike prices do not necessarily have to be equally spaced out. It is ok to have a bias one way or another. This is because the iron butterfly strategy is designed to allow some bias in either direction should a trader believe that they stand a better

chance by adapting a bias on either side. Also, these iron butterfly strategies can be switched or inverted such that a trader can assume short positions on the winds of the butterfly while long positions are applied at the middle strike price. You can use this approach profitably when there is relatively high volatility affecting the underlying stocks.

This strategy can also be thought of as a combination of a short call spread together with a short put spread. The spreads in this instance will all converge at the strike price B. Now since this strategy is a combination of two short spread strategies, it is possible, for a net credit, to create an iron butterfly. The purpose when implementing this strategy is for all the options to expire worthless at expiration of the strategy. Even then, the chances that this will happen are very little so it may be necessary to pay an amount just to close the positions.

Setting Up the Strategy

In this set up, you will first buy a put option at strike price A and then sell a put option at strike price B. Please note that these are all put options up to this stage. The next step is to deal with call options. You will sell a call option at strike price B and then buy a call option at strike price C. In this instance the price of the underlying stock is at strike price B. At this juncture we choose to have the strike price equidistant with all options sharing the sane expiration month.

Pros and Cons of the Iron Butterfly Strategy

The iron butterfly strategies have a number of beneficial aspects to it. Traders can use this strategy yet spend minimal amounts of capital. They can generate a steady income with lower risks compared to other forms of spreads such as the directional spreads. It is possible to roll down or up the butterfly strategies should the price begin to extend beyond certain ranges.

You will also have the benefit of clearly defined risk to reward ratios. In this instance, the maximum possible profit for the trader is the net paid premium. Also, the maximum loss is known in advance, it is defined as the difference between the net loss of the short and long call options or perhaps the short and long put options less the premiums initially paid.

An Introduction to Volatility

Definition

We can define volatility as a statistical measure of the levels of fluctuations of a stock, shares, or the entire market. The value is calculated as the ASD or annualized standard deviation of the price swings of a security in terms of daily percentage. The value is expressed as a percentage.

Historical volatility

Historical volatility is simply a measure of a security's volatility in the past. When computing this figure, you will have to define a specific period in time for consideration. One of the most common figures used for historical volatility is the twenty day period. This specific measure approximates total trading day numbers within a month.

Implied Volatility

Another useful term is implied volatility. This measures the volatility that is implied by the prevailing market price of the stock's options. Implied volatility is computed using one of the main option pricing models like the Black Scholes Model. Using this or similar models, you can work out volatility where a mathematical relationship has been established relating the price of an option and the volatility of the underlying stock.

Basically, implied volatility provides insights into the market's view of the options contracts' underlying security. It can be determined by making use of the following;

- Option's current market price
- The value of the underlying security
- Expiration dates
- The strike price
- Any applicable interest rates
- Any applicable dividend yield

In an ideal situation, we would expect the implied volatility figure to be the same for all options that have the same expiry date. This is regardless of the strike price that was used in our computations. In

practice, however, this is hardly accurate because the figures we get vary mostly due to strike prices used. This variation in volatility is known as the volatility skew.

The Impact of Volatility on Options Trades

We have already established what the term volatility means in options trading. It is simply a measure of the size and rate of the price change of the underlying security. High volatility implies high option premium. The reverse is also true.

If you can assess accurately the value of statistical volatility for an underlying security, you will be able to use this value into a pricing model for purposes of computing a fair market price for the option. It is crucial that, as an options trader, you keep in mind the fact that changes in volatility can greatly impact your trades either negatively or positively.

Implied vs. Historical Volatility

As a trader, you can choose to apply the implied or historical volatility in order to determine if the options are costly in comparison to previous price levels or affordable. You should be able to make a determination about whether the options you are interested in are under- or overvalued. This is in relation to market prices versus theoretical prices and makes use of both implied and historical volatility.

Black-Scholes Model

All options traders, whether new or experienced, are aware of the Black-Scholes model. This is an options pricing tool that was developed in 1973 by Myron Scholes and Fisher Black. This tool makes use of a number of variables in order come up with a fairly priced option.

Some of the variables used include historical volatility, time to expiration, and the strike price. Many options traders hardly bother to assess the true market value of an options contract prior to taking a position in the market. This is puzzling largely because these same traders would not dare buy a house or car without at least finding out the true value or market value of these assets.

If you keep volatility in check at all times but especially when coming up with your trading strategies and considering a fair price, you will be able to accurately value the options. Options usually

take expected events into consideration. Therefore, you should determine whether or not options are costly or affordable in order to know whether to buy or sell them. Of course you should always aim at the old adage of buying at low prices and selling at a high price.

The Concept of Moneyness

The term moneyness in finance refers to the position of current price of an underlying security relative to a derivative's strike price. This term is most commonly used with call and put options. Remember that options are a type of derivative because they derive their value from an underlying security.

The term moneyness expresses an option's intrinsic value in its present state. This term is very common with call and put options. It is a great indicator on whether the option will be profitable should it be exercised. A positive intrinsic value means that a derivative is in the money while it is out of the money if it expires at the prevailing price. When the strike price and the current price are equal, then the option is said to be at the money.

You can measure the level of moneyness in relation to an underlying stock or simply any other asset's current or future price. The moneyness of an options contract reveals to a buyer whether exercising it would be profitable or not. Moneyness generally examines an option's value if it were to be exercised right away. An options contract that is out of the money results in a loss while in the money means a profit. An options contract that is at the money simply implies a breakeven situation when the option is exercised.

An Example Showcasing Moneyness

The prevailing price of ABC stock is $100. A trader writes an option with a $100 strike price which is at the money. Should the trader exercise this option then it would end up as a breakeven trade. On the other hand, the trader may write a $120 put option which is in the money. It is said to be in the money because the holder would be able to sell it at a higher price. This is a put option because a call option on the same security and amount would be too expensive compared to the price of $100 prevalent in the market.

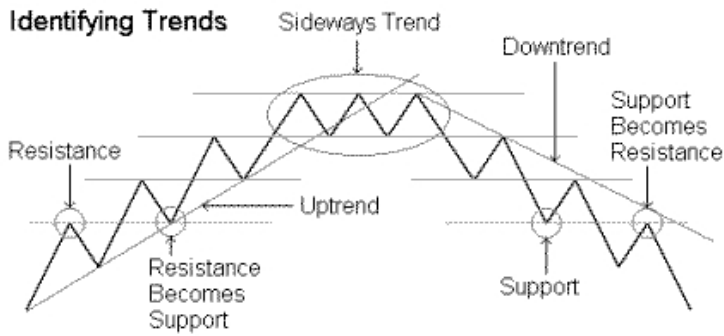
Therefore, an option can be in the money, out of the money, or at the money depending on various factors including market conditions. These are all expressions of the moneyness of a derivative such as call and put options. A trader can measure the moneyness of a position and determine whether a trade will be won

or loss.

Chapter 6:
Trader's Mindset and Tips for Success

A lot of traders are largely focused on trading and earning profits. They are hardly ever concerned about the mindset and how they are supposed to handle emotions and feelings as they trade. A lot of the time they focus on trades and celebrate when they win while feeling bad when they lose. This is actually not the best approach according to experts.

To be a successful trader, it is crucial to understand the reasons why some trades do not work out and why some lose money. By understanding why some trades lose money, it becomes possible to make adjustments so that these can be minimized as much as possible.



Winning Trades

All traders, even the most experienced win some trades and lose some. The difference is the number of losses and reasons for the losses. Skilled traders are able to discern with relative accuracy the directions of the markets and chances of making winning trades. However, it is really difficult for anyone to perform better than the markets.

No trader can outperform the market yet most traders are unable to grasp this simple principle. The most crucial initial step is to select winning trades. This is a skill that needs to be learnt. A trader should have an edge as this increases chances of winning. If a trader has no edge, then he or she can only emerge victorious about half the time.

There are two things that an options trader should focus on. The first is to ensure to earn a profit of at least 50% or more. Also, money lost from any losing trades should not exceed that earned from winning trades. This calls for some skill development. An options trader should take time to develop the necessary skills on how to identify such trades.

Risk Management

One of the skills required for successful trading is risk management. One of the best approaches is to ensure that losses are kept at a bare minimum. Apart from this, we also need to learn about a trader's mindset. There are other aspects that need to be considered as well.

A Trader's Mindset

The first and most important aspect is for a trader to identify one or more strategies that they are very familiar and comfortable with. Such strategies should be adapted and then applied whenever market conditions permit. For instance, iron condor strategies are best suited for markets whose volatility was initially high but steadily declining. Naked put selling and covered call writing are strategies suitable for a moderately bullish market.

Another crucial skill to learn is technical analysis. There are traders who solely rely on this technical skill to enter and exit trades. Technical analysts need to develop their chart reading skills. It is never easy and the process is not learned overnight but takes some time. While there are never any guarantees for success, chances for success are significantly higher when such skills are developed and optimized.

For success, a trader needs to focus on investigating all the signals and cutting losses. The key point in this instance is learning which ones are strong and which ones simply breakeven. Also all traders should never trade just for the sake of trading. This is because trading is done with an aim and purpose. The purpose is to be profitable. If trades are not working out then it is advisable to pause for a while and take a breather. Traders should only enter trades they have prepared well for and have a suitable plan of execution.

Options Trading Psychology

Trading options is a process that revolves mostly around three major factors. These are money management, trading strategies, and psychology. You need to keep in mind that the markets can be a very emotional place so it is crucial that you remain focused and disciplined. If you do not stay disciplined, then you will lose out and others will very likely take advantage of you.

What you really need to do in order to trade successfully is to have a solid strategy, follow the strategy and stick to it. If the strategy does not follow the intended plan, then simply quit and come up with another strategy.

If you have a strong mindset, you will be able to understand when to pursue a losing trade and when to quit. If you lack discipline, then one of two emotions will take over. These are greed and fear.

Sometimes traders trade on a whim and keep posting random trades. Rather than take this approach, you really should focus on a successful strategy which you will pursue until you need to exit. You should also have goo trading skills and proper money management plan. With these in place, you will be able to focus better and thin in terms of probabilities and risk-reward rations. This way, you will not leave room for emotional trading.

Additional Trading Psychology Tips

There are other things that you need to also keep in mind. For instance, you need to develop and stick with good trading habits. As a trader, you need to note that a winner is one who is persistent and consistent. You should develop the habit of closely studying the markets, conducting your analysis, and position sizing.

Position sizing is especially prevalent in a volatile market. As such, you need to take care of your downside risks and ensure that you position size appropriately. You should also envision the end game. Come up with a vision of where you want the trade to head then prepare to make any necessary adjustments.

You also need to accept any possible failures. Sometimes your strategies will not work out and you will lose some trades. This happens to all traders, even experienced ones. If you assume that you must succeed on each attempt, then you will be setting yourself up for failure.

Great Tips for Success

1. Option Prices Can Money in One of Three Ways

It is important that you understand that a stock price can move in one of three directions. The price can go up, go down, or remain the same. Plenty of traders believe that the stock price can only go up or down. However, this is completely wrong.

Stocks can remain static without moving in either direction. As a trader, you need to always factor this as a possible outcome. Sometimes stock prices do not move much. They either remain within a narrow trading range or simply not move at all.

Sometimes we may think that when we buy a call option, we have a 50% chance of making money because we think the underlying stock has a 50% chance of gaining value. The truth is, there is only a 33% chance of making money. This is because if stock price movements are truly random, then 1/3 of the time they could rise, 1/3 of the time the prices could go down, and 1/3 of the time stock prices could remain flat.

For instance, if you buy an out-of-the-money call option, you are betting that the stock price will rise so that you make a profit. However, the stock price could remain static or go down. When either of these two events happens then your options will definitely expire worthless and you will lose your money.

Let us assume that the price remains the same. Then if you purchased an in-the-money call option, you can expect to receive at least the intrinsic value back. This cash is also known as in-the-money amount.

One of the most frustrating aspects of options trading is that a week after your options expire, you can the stock price rise astronomically. This is a clear indication sometimes that you did not give your strategy sufficient time. Instead of buying month-long options, choose longer-period options like year-long. This is one reason why longer-term options are much costlier than others.

2. Always Study the Charts of Underlying Stocks Before Buying

You should never buy a call or put option without studying the chart of the underlying stock. Studying the charts and carrying out

some technical analysis will give you a clearer and more reliable outlook about the future movement of the stock. You really should study keenly the 1-month, 3-month, and 1-year charts. You will be looking for resistance, support, trends, and channels.

You need to be keen with your observations after looking at the charts. How is the stock behaving? Are there any sharp declines or slow and long declines? Are there any patterns that are consistent with your initial strategy? You should then be on the lookout for the trend.

To find the trend, what you need to do is to first identify the overall direction that the stock price is headed. Once you identify the direction, draw lines at the bottom and top so as to show the channel that the stock is trading in.

Use this information to make predictions about possible price movement. If you think the price will keep rising, then you should think about buying a call option. Also, if there is an expected earnings report or other crucial company event like a product launch or shareholder meeting, then a call option is advisable.

Basically, if the stock chart shows solid support at lower prices, then you may want to buy a call option. However, if there are resistance levels at higher price and the stock price starts approaching these levels, then you should consider buying put options.

3. Find best Priced Options Using the Option Chain

The next step you need to follow is to look at the option chain. This is the page where options are listed. When you examine an option chain, you will notice lists of all put and call options available on a particular stock. The chain will also show the strike prices and expiration dates for all the options.

The first thing you look at after observing the options available is the expiration dates. The next is the strike price. Another useful parameter that you should look out for is the volume. Avoid any options that have little or no volumes. Lastly, you will need to look as the spread between ask and bid prices.

4. Calculate the Breakeven Point

Always ensure that you find out the breakeven point of your trade before actually buying it. This should be your next step after identifying your preferred call or put option. You really should learn how to calculate the breakeven point. The process is not difficult at all.

First find out the difference between ask and bid prices. This is known as the bid spread. Now if this spread is $0.20 and the commission is $10, then to break even, the bid price will have to increase by $0.30. Basically, you will pay $10 to buy the option, $10 to sell it and at least $10 to beat the spread. This means you start at -$30 even before trading. Therefore, you need a minimum return of $30 in order to just break even.

5. The Trend is your Friend

You need to keep in mind that the trend of the underlying security always works in your favor. Once you identify the trend based on your chart analysis, you should then identify the trend and follow it. If you go with the trend, then you are very likely going to succeed.

On the other hand, going against the trend is dangerous and a risky venture. It is highly advisable to go with the trend and never against it. Resistance is futile while momentum is actually your friend.

6. Keep a Look Out for Earnings Release

It is absolutely crucial when trading stocks and options that you should be on the lookout for earnings release dates and announcements. These announcements have a huge impact on markets, stock prices, and on options.

There is usually an anticipation of earnings reports because strong or weak earnings could cause the value of the underlying stock to move in either direction significantly.

What happens is that options prices will decline shortly after an earnings release announcement. Once the earnings report is over and the market receives the information, stock prices will basically resume normal levels. The volatility will eventually subside.

7. Ride on a Winner if you Get One

Stock market experts often advice traders to, “ride your winners”. This simply means that if you get a profitable trade then you should stick with it for as long as you can. It is advisable to let the stock price continue with its movement for as long as it is profitable.

Inexperienced traders may wish to cash out then get back in. However, experienced traders will stick with a trade and ride it to the end. Momentum is likely to carry it further.

7. Learn to Cut your Losses

Novice traders often stick to a trade even when it is losing money. They often believe that they can recoup the losses. However, sometimes you need to admit that your strategy did not work out, cut your losses and exit a trade.

Mistakes that should be avoided

There are certain mistakes that are common with novice traders. Here is a look at some of these mistakes and how to avoid them.

1. Buying out-of-the-money Call Options

One of the most difficult ways of making money is to trade out-of-the-money call options.

2. Applying an all-purpose strategy in varying market conditions

It can be tempting to apply an all-purpose strategy because it has shown success in the past. However, you need to craft options trading strategies depending on the market. One of the best strategies that you need to understand is the long spread.

3. Having no Exit Plan before Expiration

You need to have a definite exit plan at all times. This is true even when riding on a winner. A definite exit plan will help you exit at the right moment based on your analysis. It is crucial as a trader to avoid the temptation of hanging on to a trade too long.

4. Making up for Previous Losses with Risky Strategies

Sometimes traders, especially novices, think that they can recoup past losses. Ideally, when a trade does not work out in your favor, you are likely to ignore risks and make irrational decisions. You should never succumb to these temptations. Instead, count your

losses and focus on doing better on your next trade.

5. Trading Illiquid Options

Avoid trading illiquid options because these are usually poorly priced. Also avoid options on stocks with low volumes. Liquidity is absolutely important and high volume stocks are very liquid.

Trading Forex Options Tips

As a trader, the more experience you gain, the more variables seem to be at play. Some of these may improve your performance while some may not. In most cases, these just add layers of complications and are mostly settings and indicators.

It is advisable to focus on factors that actually support your trades and enable you to perform and increase your profitability. Here we shall examine a couple of tips that will help you become a better and more successful trader. These tips are directed at intermediate traders even though others too could benefit from these tips.

One of the most crucial factors in Forex trading is consistency. If you wish to develop and become a successful Forex trader, then you should be consistent. Being consistent is absolutely essential yet most people are not even consistent in their lives. There are certain platforms that provide systems with a set of reasonable rules. Following these rules helps traders to perform well, excel, and become successful.

You need to keep in mind that Forex trading is all about taking risks. However, these are measured and calculated risks rather than blind groping in the dark. As a Forex trader, you are mostly a risk manager so you need to be totally vigilant as you place traders and invest monies in your trades. There are a couple of things you need to focus on once the trades are entered.

Find Triggers

One of the first things that you need to do after placing a trader is to dial down for triggers. This is one way of managing risks and lowering your risks. When you lower down your risks, you improve your chances of success and as such you can go for a great size.

To achieve this successfully, you will need a chart that makes use of

Fibonacci symmetry and retracement. Such a chart will have a slanted line and an upper line. Find the upper line because it is the trigger line. This line basically indicates or points to the nearest level that has to be broke just so you may continue with the upward trend.

As an intermediate Forex trader, you should endeavor to identify a pathway to enter the trade at a point that is nearer to the market's determined turning point. In order to find such an entry point, you will basically do what is known as down dialing.

With a good chart, you should be able to trade with a risk profile of close to 78 pips. At such a level, the price will begin to showcase another preferred entry point. At this stage, you will want to enter the trade at the 51 pips level with a buffer of about 5 pips. The most likely scenario is that the trend will begin an upward climb. What this will have achieved is reducing our risk profile by 50% and allows you better performance with higher performance at the end of it.

We can be Wrong Sometimes

By now we know that even the best analysis does not always win. There is never a 100% guarantee that the market will move as predicted. It is therefore the reason why you can take the risk out of the trade.

Go for Profits

As an intermediate trader, you have learnt all about setting up trades, learning how to enter and exit trades, how to identify great opportunities, how to read charts and all that. By this stage now, you should focus on profits. This is because we learn all this technical stuff in order to eventually learn how to be profitable. There are different ways of going about this. There are generally two great ways of doing this. These are using moving averages and using price structure.

You can also keep close track of your stop by using one of the moving averages. Using such approaches for profits will help remove emotions from your trades and enable you to trade with confidence and thereby become profitable.

Effective Indicators that you should be Aware of

As a Forex trader, you are likely to encounter plenty of various trading methods. It is possible to make use of only four chart indicators. These can help you with almost all Forex trading opportunities. These chart indicators are the MACD indicator, the Moving Average, Stochastic, and the RSI. As a trader you will receive Forex indicators and free reinforcement tools to use each and every trading day.

Use a Simple Strategy

A lot of traders tend to complicate matters especially in their early trading days. As an intermediary trader, you should try as much as possible to avoid complicating things. Instead, you should focus on more on simplifying your trades so that everything is clear and all what you do must have a clearly defined purpose.

Plenty of traders are of the opinion that complicated trading strategies with plenty of variables perform better yet the main focus should be on simple strategies that will have a direct bearing on profitable trades. Also, strategies that are simple and straightforward have less stress and allow for fast reactions should this be necessary. As an intermediate trader, you need to work on coming up with simple strategies that are effective and will help you identify trades.

2. Tips for Options Traders

As a futures trader, you should make sure that you understand very clearly what a short position is and a long position is. There are plenty of novice traders who believe that you only make money or are profitable when markets are on an upward trend. However, you need to understand that futures' trading constitutes a lot more than just following the upward market trend. You also should know by now that as a futures trader you can benefit greatly when you focus on asset types that have attained a climax and are close to failure.

As a trader, anytime that you wage your money against an asset, then you will be said to be selling it short. Selling an asset short simply means that you will engage your broker and purchase the rights to access the asset with the hopes of selling it back later once it becomes profitable. Using this analogy, we can purchase apples at

the market for $1 each and then selling them back at $2 each making a profit of $1.

In real life, this $1 can be exponentially multiplied to earn you large sums of money. This is the way futures markets work. You stand to make large sums of money from simple trades.

Long Positions

As a futures trader, you are ready to invest your funds in a particular asset when you take a long position in it. In this situation, you will only benefit from this position when the price of the asset rises. As a futures trader, you need to be able to determine whether and when an asset is likely to rise in price. This determination requires you to learn about the fundamentals of the asset. For instance how is the supply and demand in the market? Being able to answer such questions with a high level of accuracy will enable you to make the decision about whether to invest in it or not.

Basically, each asset market has its own rules that help interested parties, including traders, to provide intrinsic value as well as determination of momentum, both negative and positive. The Central Bank is the premier institution when it comes to currency so currency traders need to take note of the policies and statements released by this institution.

In this instance, currency fluctuations sometimes depend on interest rates. If you anticipate a rate hike, then it is advisable to go long on the specific currency. Higher interest rates should provide a suitable incentive to hold long an asset. This way, there will be increasing demand in the currency and you will be able to eventually sell at a great price and make lots of profits.

When it comes to stocks and other instruments, it is corporations that drive their value. For instance, earnings report will determine the value of a company's stock in the short and long terms. Earnings reports are often released quarterly. During these events, company executives reveal their earnings for the past three months as well as their forecasts for the future. Therefore, if a company announces a reduction in production, closure of a store or plant and so on, then you should assume a long position. The reason is that reduced

production will very likely result in higher prices within a couple of months.

Short Position

When it comes to short positions, there are plenty of similar factors compared to long positions at play but in reverse. Therefore, factors or elements that cause you to choose a long position will, in reverse, determine a short position. For instance, if you are interested in currency and there are signs of reduced inflation, then you may want to take a short position on the currency.

Basically, when there are signs of declining inflation, central banks may decide to lower interest rates in order to provide a stable financial position in the markets. On the other hand, when interest rates are high, then as a futures trader, you will want to take the path that all other futures traders do. When interest rates are high, products and services are generally expensive for the consumer.

Costly products mean lower sales figures and this will mean reduced incomes for corporations and so on. As such, it will be appropriate for futures traders to sell short because of the high interest rates. Some of the instruments that can be sold include shares and stock indices. Commodities markets and their instruments also operate in the same manner. When there are high interest rates at play, the markets tend to experience low demand. Commodities such as gold and oil will then most likely begin selling short at the markets.

Basically, it is advisable to have a good idea regarding factors that are actually negative and which ones are considered positive especially in regards to your preferred asset. This way, you can do your research and analysis to determine if you are to sell an asset or buy.

Options trading can be an extremely profitable venture. The potential for making money are huge especially using advanced strategies. A lot of traders have seen their fortunes change, not overnight, but over a period of a couple of years after trading options. Profitability levels up to 700% are possible. In fact, they say that profitability can be unlimited depending on the strategy adapted.

There are some caveats as well. Options trading can be risky especially when practiced by traders without the proper knowledge or understanding of how options work. Some strategies are pretty risky and can expose a trader to larger losses than they bargained for. This can be pretty dangerous as it could wipe out a trader's capital and reserves and render them broke. Therefore, due diligence, proper understanding of options strategies, and proper trading psychology are the most important ingredients for successful trading

Conclusion

Thank for making it through to the end of this book, let's hope it was informative and able to provide you with all of the tools you need to achieve your goals whatever they may be.

The next step is to perfect any preferred strategies until you are able to execute them with ease and profitably. Only after you understand exactly how to trade options should you endeavor to go live and trade on a live platform. The best approach is to identify your favorite strategy and then work on perfecting it.

Finally, if you found this book useful in anyway, a review on Amazon is always appreciated!

SWING TRADING

Learn How to Trade Stocks, Forex, and Options to Generate Consistent Profit. A Beginner's Guide with Effective Strategies for Becoming a Successful Swing Trader

Introduction

Congratulations on downloading Swing Trading and thank you for doing so. Swing trading is a trading technique mostly used by traders in different trading markets. It is a short-term technique that involves selling and buying stock over a tight time period, normally less than two weeks. Swing traders use technical indicators to predict trends of the market and make some short-term profits. Swing trading can be used as your main trading strategy or as one of many different strategies. In this swing trading guide, we will look at the important information you need to know if you decide to give this strategy a try.

Though the book covers the essentials in simple terms, experienced traders will still find useful tidbits throughout. For example, the book teaches traders how to think about managing risk as well as money. Other topics, such as how to analyze stock charts, determining entry and exit points, instruments and strategies used in swing trading, managing risk, Fundamental and Technical Analysis, and trends in swing trading are covered as well. The most compelling feature of this book is a series of real-world examples that illustrate concepts covered. These are presented in a clear and easy to understand way that beginners and pros will appreciate.

The book does a respectable job of laying out the risks of swing trading as well. Rather than just focusing on the positive, the author does a nice job of explaining common pitfalls and how to avoid them. This book packs a lot of information into an accessible, concise package. It is a great jumping off point for the new trader looking for broad background information.

There are many books on this subject on the market, thanks again for choosing this one! The author made every effort to ensure it is full of as much beneficial information as possible; I hope you will enjoy reading it!

Chapter 1:
What is Swing Trading?

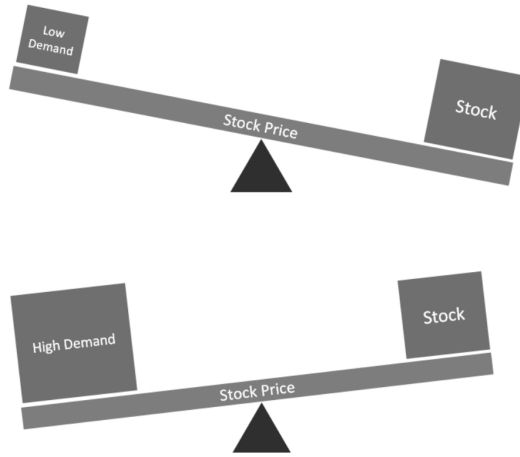
Definition of Swing Trading

Swing trading is often compared to fundamental trading, which is a trading strategy in which investors monitor and analyze company-specific events to decide when to buy a specific stock, how long to hold it and when to sell it. If you are trading in fundamentals, you are usually swing-trading, since any company-specific events will tend to affect stock prices over a few days or even a week or so, rather than on an hour-to-hour basis. There is a little more to swing trading than that, however. Most swing traders use a combination of different technical indicators to decide which markets to invest in and how long to hold their stock.

The trading behaviour of a typical swing trader generally sits somewhere between that of a day trader and that of a trend trader. Day traders may hold stock anywhere from a few seconds to several hours, but all their trades will be completed within a day. A trend trader focuses on long-term fundamental trends and may hold stock for weeks or even months. A swing trader will tend to hold stock for anywhere from a few days to two or even three weeks. Swing traders are aiming to make a fairly quick profit, but they are looking at price changes over a slightly longer period of time than day traders and are trying to predict longer-term price movements, usually using a combination of a few different market indicators.

Swing trading is a trading technique that traders use to buy and sell stocks whose indicators point to an upward (positive) or downward (negative) trend in the future, which can range from overnight to a few weeks. Swing trades aim to capitalize on buying and selling the interim lows and highs within a larger overall trend.

Traders use technical indicators to determine if specific stocks possess momentum and the best time to buy or sell. To exploit the opportunities, the traders must act quickly to increase their chances of making a profit in the short-term.



What Technical Indicators Do Swing Traders use?

If you are interested in this strategy, you will want to learn about the technical indicators traders use to try and predict price changes. This involves a lot of examining charts and tracking price movements, but there are various apps and software that can help you. You may want to consider:

- A moving average
- A relative strength index (RSI)
- A point & figure (P&F) chart
- A Fibonacci retracement chart

Many swing traders use either a simple moving average or an exponential moving average to identify or confirm a market trend. There are various charting apps that incorporate a moving average. A commonly used system based on an exponential moving average is the Bollinger Bands system. You can also use an RSI indicator. Many traders consider this the best technical indicator for swing trading, giving you a strong indication of when conditions are optimal for entry into a market. You can use your RSI indicator alongside a system that incorporates a moving average. Other indicator options include a P&F chart, which presents periods of rising and falling prices as a grid view, and a Fibonacci retracement chart. Technical indicators only become stronger (in terms of accurate predictions) when used with other indicators. It makes sense to learn your way around one technical indicator at a time,

but when devising your own trading strategies, be aware that the more indicators you are monitoring, the more accurate your market predictions are likely to be.

When to Swing Trade

Swing trading is a strategy that can be used in different markets and on any trading platform by traders of all levels. Before you start, you'll have to decide which broker to use, and your broker comparison research should look closely at trading fees and commissions. You will be buying and selling regularly, so your cost per trade is an important figure. You can use this strategy when trading stocks, futures, options and Forex. While you can deal in any kind of stocks as a swing trader, you will find that there is often an advantage in trading large-cap stocks, simply because they are the most frequently traded stocks on all major stock exchanges.

As a swing trader, you will benefit when markets are fairly quiet and ranging, as you will be able to make a lot of small short-term gains. A sudden upwards trend will afford you an opportunity to make a bigger profit if you buy at the right price point. An extreme bear market or bull market, however, makes things challenging for swing traders. In these markets, momentum will tend to take prices in only one direction for a relatively long period of time. You will not see the same small fluctuations in stock price that you see when the market is stable for a long period of time, and it is those continuous fluctuations that allow swing traders to make small but regular profitable trades.

Strategies Used in Swing Trading

This method is, of course, a strategy in itself, but you will also have to develop your own specific trading strategies based on the technical indicators you want to use, the stop-loss limits you want to set and other variables important to you. Take time to consider all these factors and get everything in place before you start trading. In a ranging market, you will probably want to go with a very straightforward "buy low, sell high" strategy, but it is also possible to swing trade in a trending market. Even in an uptrend, for example, there will often be a step-like or zigzag pattern as a stock pulls back slightly before continuing an uptrend.

Bullish swing traders will use a stock rising out of a 'step' to try and take a profit before the next small pullback. For most swing traders

though, a ranging market is an ideal one to work in. Many swing traders will start with a very simple strategy, often using a tool such as Bollinger Bands, which use that exponential moving average we referred to earlier to create a 'support and resistance' system. Once you can accurately use this system to find a ranging market and identify the best times to buy and sell, you have one of the most straightforward strategies used by swing traders at your disposal, and you can begin to experiment.

Benefits of Swing Trading

a) A wide variety of trading opportunities

Swing traders enjoy multiple investment vehicles to test their swing trade theories. They can trade single stocks, groups of stocks bundled in funds, and even apply swing trade strategies to cryptocurrencies like bitcoin and Ethereum.

b) A wide variety of trading tools

In addition to having myriad investment trading options to choose from, swing traders can also avail themselves of a growing number of swing trading platforms (such as Meta Trader) and strategic resources (think mobile apps, video training sessions, and Trip Advisor-like online chat groups who have engaged in swing trading in the real world.)

c) Swing trading is an effectively straightforward proposition

Trading securities is complex-there's no doubt about that. But swing trading, relative to other trading strategies, can be fairly simple. For example, most swing traders focus on large-cap stocks to trade, as more sizable stocks tend to offer the volatility and volume needed to capitalize on swing trading opportunities. Eliminating smaller stocks from the equation is just one example of why swing trading is an easier trading strategy to embrace for investors.

Downsides

a) Swing trading does offer risk-and anxiety

There's really no other way to say it-swing trading is risky and can lead to significant portfolio losses if you guess wrong. Consequently, if the thought of undue market risk and losing a bundle of money has you reaching for the Xanax, swing trading is not for you.

b) You will need to frequently monitor your trading positions

As the old saying goes, time is a commodity, too. With swing trading, you'll need to schedule a great deal of time away from your actual life to monitor fast-moving trading positions. We're not talking taking a peek at your swing trading position every few days or so. Instead, you'll be checking your trade on the hour in live market trading conditions, taking you away from your job, your family, your friends, and your life in general.

c) In extreme markets, swing trading is problematic

In full-bore bull and bear markets, swing trading can be challenging. That's because more stocks and funds are in full-volatility mode and won't necessarily move in the way a swing trader needs an investment vehicle to move when financial markets are swinging as a whole for several weeks at a time.

Is Swing Trading Good for You?

If you have got the time and you have got the money-and you can bear the risk-a small investment in a swing trading strategy that uses a professional trading platform can be well worth your while. At best, you'll learn a great deal about financial pricing oscillations and how they impact individual securities and make some money in the process. At worst, you'll lose some money but will gain a valuable market management education.

As long as the amount of money involved is not too substantial and the risk involved too high, swing trading can work-under the right conditions and for the uniquely risk-aware investor.

Chapter 2:
Swing Trading versus Day Trading

There are pros and cons to any kind of trading, and it is important to consider them before diving into any new platform or strategy. Swing trading has many merits over other trading styles such as day trading. Some of the advantages of this type of trading include:

- You can take advantage of market fluctuations
- You can create clear boundaries
- Easier to spot new opportunities
- Less stressful
- It requires just a few minutes every day to manage your open trades unlike day trading.
- Swing trading offers larger targets and plenty of time to open trades.
- You tend to have the option of a larger stop loss placement meaning that swing trades are less sensitive to small changes in price (whipsaw) that happens most of the time we have news announcements or during the market day.

Markets are always moving, and swing traders take advantage of those rises and dips. You can use your chosen technical indicators to set clear boundaries for all your trades. You can decide in advance how much profit you want to take or which metric you will use to decide a trade is working against you and limit losses. By completing trades over short periods of time, you spread your risk and tie up less capital at any one time than you would if holding stock long-term. By being constantly in and out of the markets quickly, you can learn to look ahead and spot the next trending opportunity. As we have already mentioned, swing trading can be less stressful and require less intense focus than fast-paced day trading, but it is also sometimes less stressful than trend trading. Stop losses are typically smaller on short-term trades. Most swing traders will cut their losses early and move on to a new market. Examples of such markets are listed below:

- Forex market
- CFD market
- Stock market

Day Trading

Day trading is buying and selling of financial instruments such as stocks with the objective of making a gain from the gap between the selling price and the buying price. Day trading is different from other trading styles because positions are closed in less than 24 hours. Open positions are rarely held overnight in day trading. They are closed before the market closes for the weekend.

There are various strategies employed in day trading such as scalping. Scalping is short-term trading where positions are held for a few minutes or seconds. Swing and position trading are longer-term day trading strategies where an open trade remains open throughout the day of trading.

Forex trading styles are majorly categorized depending on the length of time that the trader holds a position and expects it to win. Some traders prefer to hold positions for weeks while others would prefer to hold for minutes or even hours.

Day trading refers to the short term trading style where a trader closes a transaction within the day without holding it overnight. In most cases, the trader takes trades for a day and closes it as soon they hit the target any time before the day is over. The traders act on their bias and pick a side at the beginning of the day and at the end of the day, they close with a profit or loss. Day traders do not like holding the trades overnight. This style of trade is best suited for people who have enough time in a day to analyze, monitor and execute a trade within a day.

One can be a forex day trader if he or she likes to initiate and end a trade within a day, has enough time to closely monitor the market trends throughout the day especially in the morning, and likes to know if he or she won or lost within a trading day. If one does not have enough time to analyze the markets throughout or for the better part of the day, has a day job that requires too much attention, or likes longer or shorter term trading, then he or she might not be able to participate in day forex trade.

There are some things that one should consider before venturing into day trade, for instance, a trader should ensure that he or she has a means of staying updated on the latest basic events. The

knowledge allows one to choose a direction and make decisions at the start of the day. If one has a full-time day job, they need to take serious considerations because it will be required of them to divide the time between work and trade. Basically, the person might get fired if he or she spends too much time looking at the charts during office hours.

There are different types of day trading including, Trend trading, Countertrend trending, and break out trading. Trend trading involves situations where the trader observes a longer time frame chart and determines the overall trend. After that, the trader moves to a smaller time frame chart and analyses the trading opportunity following the trend. The trader uses the indicators on the shorter frame to get an idea of when they should time their entries. Countertrading, on the other hand, has works like the trend trading but the trader looks for opportunities in the opposite direction after observing the overall trend. The idea behind countertrend trading is to identify the end of a trend and make an early entry when the trend reverses. Countertrend trading is riskier but a trader can have huge profits when used correctly.

Break out trading refers to the situations where a trader looks at the range made by a particular pair during certain day hours then placing a trade on either side while hoping to get a breakout. Breakout trading is particularly good when the pair has been in a tight range because that indicates that the pair will make a big move in a short while. The goal of the trader in the breakout trading is to position him/herself strategically such that once the move occurs; he or she catches the wave. In the breakout trading method, the trader determines the range where resistance and supports have been holding strongly then setting the entry points either below or above the breakout levels. The rule of thumb in this trading is to target an equal amount of pips making up the determined range.

The techniques of a day trader

Day traders follow the events that lead to short term market changes. One popular technique that the day traders rely on is trading the news. Market psychology and market expectations identify that markets react to scheduled announcements such as corporate earnings, economic statistics, and interest rates. Markets

react drastically when the set expectations are exceeded or the expectations have not been met and the significant price movements can benefit day traders vet much.

Day traders also use the fade the gap technique to get benefits within a short period. When a trader observes a gap between the day's opening and the closing of the previous day he or she may take a position in the opposite direction, therefore, closing the gap. During the day when there is no news, gaps are rare. However, the traders still take a view on the direction that the market is generally moving to. If a trader anticipates that the market will move up, he or she may buy securities that display strength when their prices fall. In the cases where the trader observes a downward trend in the market, he or she may sell the securities that show weaknesses when the prices bounce. Many independent day traders use short days whereby they work for 2 to 5 hours per day only. In many cases, the traders will practice their trade skills on a demo account before going live. Demo accounts help the traders to track the failures and successes compared with the markets, therefore, they learn through experience.

Common mistakes made when day trading

The foreign exchange market is very extensive and has very few barriers to entry. Consequently, it is one of the most accessible markets across the globe and anyone can access it from wherever. Theoretically speaking, if one can access the internet, has a computer or a smartphone that supports trade and some money, and then he or she can start trading in the foreign exchange market. Many new entrants into foreign exchange start with day trading. However, the ease of entry does not represent the ease of making profits as many people assume. There are some common mistakes that day traders make leading to failure.

First, many traders fail to record their ratios. As a day trader, there are two identified statistics that one should keep an eye on; the risk /reward ratio and the win-rate. A trader's win rate is the number of times a trader wins expressed as a percentage. For instance, if the trader wins 80 times out of 100 then the win rate is 80 percent. A day trader should maintain at least a 50 percent win rate. The risk-reward ratio represents the number of wins in relation to the number of losses in an average trade. For example, if a trader loses

an average of $500 and wins an average of $750, then the risk/reward ratio is $750/$500 = 1.5. A trader should ensure that he or she keeps the risk/reward ratio above 1 to minimize loss. Ideally, the best margin is 1.25 and this indicates a profitable trader. In some cases, a trade can still be profitable when the win rate is lower and the reward ratio is higher and vice versa.

The second common mistake made by day traders involves trading without a stop loss. A stop loss is an order to offset a trade if the prices move against the trader to a certain extent. The trader selects the amount at which the order should get him/her out of the trade. A stop loss order moderates losses and it very helpful for beginner traders.

The third mistake that the day traders make involves adding to a losing day trade. Many traders tend to average down when losses occur with the hope that the trend will reverse. Averaging down refers to the process of adding to a position while the prices are moving against the trader. This is a dangerous practice because the price can move against the trader for longer than expected therefore causing exponential loss. Instead of risking everything, one should take a trade and set a stop loss order such that once the price hits the set target, the trade is automatically closed.

Fourthly, some trades risk more than they can afford to lose. The key strategy of forex trading is identifying the amount of capital one is willing to lose if the deal goes wrong. Ideally, a day trader should risk a maximum of 1 percent of their capital in any one trade. As such, the set stop-loss order should close a trade of it leads to more than 1 percent loss in trading capital. Consequently, this will mean that when a trader loses multiple trades consistently, only a very small amount of capital will be lost. Again, the trader can make 2 or 3 percent on each win, therefore, covering the losses very easily.

Another capital risk management strategy is controlling the losses on a daily basis. Instead of using one stop loss order for a number of days, a trader should select a stop order for every day. Some days are worse than others; therefore, a trader can lose a substantial amount of capital in one day. A daily stop loss is very important to mitigate risks.

Many traders also make the mistake of going all in. Even when they have identified god strategies to mitigate loss, the traders are sometimes tempted to ignore the signs and take too large a trade than they normally would. The reasons for going all-in depend on the intention of the trader and the purpose of the trade. For example, a trader may have experienced loses in a row of trades, therefore, he or she seeks to recuperate. Again, a trader might have done so well for a period of time that they feel like they cannot lose. In some cases, trades look so appealing and the trader becomes too confident about a win, therefore, places more than the set strategy. It is best if a trader sticks to his/ her trade rule such as a 1 percent risk per trade and 3 percent risk per day. If one risks too much capital, they might make a mistake and in most cases, mistakes tend to compound. When the risk fails to pay off, a trader may cancel his or her stop order with the hope that the trade will turn around. In other cases, a trader will be tempted to add to the position still hoping that the trade gone wrong will turn around. To avoid such temptations, it is best if the trader identifies a risk management strategy and sticks to it without going all in.

Beginner traders also try to participate in the news because it seems like a favorable way of making a profit. Many trade pairs fall and rise sharply to reflect the news released to the world about the economy. Many traders especially the experienced ones identify the possible movements in the trade based on the news and take a position before the information hit the market. In some cases, it is a good way to make quick profits but some cases end up in extensive loses.

Often, when the news is immediately released, the price of a pair will move quickly and sharply in both directions before it can pick a clear direction. This means that some traders end up making big losses in a few seconds after the news release. The quick and sharp movement of prices in the market marks great volatility and a trader may think that it is a good thing because there is a possibility of the price swinging back to their favor. While this might be possible, there is no guarantee.

Another problem arising with the release of news is that the spread price (the difference between a bid and ask) is often much higher than usual. As such, one may not be able to attain liquidity and get

out of the position at the chosen price. Instead of anticipating and participating in the direction that the news takes the market immediately after the release, a trader should have a strategic plan that gets them into the trade after the volatility.

Day traders also make the mistake of choosing the wrong broker. One of the biggest trades that a trader can make is making a deposit to a forex broker. If the money is managed poorly, or the stockbroker out rightly scams the trader all capital might get lost. A trader should take time to choose a broker.

Traders also make the error of taking correlated multiple trades. It is said that diversification is good and we should not put all eggs in one basket. However, such statements are arguable. When a trader believes in diversification, they will most likely take multiple trades in a day at the same time rather than taking just one. The rationale behind diversification is to spread the risk. However, some beginner traders and also some experienced traders may actually be increasing their risks. In many cases, the traders will select diversified pairs that have similar trade setups. With that similarity, chances are that the forex pairs are correlated therefore the trader sees an almost similar setup in all. When the selected pairs are correlated, they tend to move together. Consequently, if a price increases in one, all the others follow and if there is a loss, it affects all the pairs. Consequently, if the trader wins, he or she wins in all the positions but if he or she loses, it will be in multiple amounts. If a trader will take multiple trades in a day, he or she should ensure that they are completely independent of each other.

In some cases, the trader will be tempted to trade off economic and fundamental data. The news of the day or the business articles displayed on different platforms can lead the trader to bias decisions. In day trading, the long term fundamental outlook tends to be irrelevant because the goal of the day trader is to implement a strategy very fast regardless of the direction of the long term perspective. While day trading, a trader should not focus on the Fundamental data because it does not affect the short term price movements. A long term analysis of a trade can make a day trader deviate from their strategy. The best option for a trader is to stick to their strategic plan to avoid gambling.

Day trading appears to be very simple and many people assume that

they will make automatic profits. As such, some traders and especially the beginners get into the trade without a plan and to some extent; it turns out to be very costly. A trading plan involves a written document that clearly lays out the procedure that the trader intends to follow. It defines the where, how, and when of the day trade. A good trading plan should include the selected markets that the trader wants to participate in, the time and the time frame of the trade, the methods of analyzing the market, and when to close the trades. It should also identify the trade risk management rules and how the trader should enter and exit the trades whether they win or lose. When a trader ventures into the forex trade without a clear plan, he or she is gambling. To avoid such cases, a trader should create a plan and even try it out in a demo account for profitability before using real money.

Simple Day trading strategies for Forex that works

Day trading strategies are very important when one is looking to capitalize on small but frequent price movements. Effective and consistent strategies depend on thorough technical analysis, utilizing indicators, charts, and patterns to anticipate future price movements.

For beginner traders; before anyone can settle in the complex world of extremely technical indicators, he or she should pay attention to the basics of simple day trading strategies. While many people believe that one needs a highly complex strategy to win in intraday trade, the straight forward techniques are more effective.

Basics

A good strategy should incorporate the following factors:

Time management- In day trading, one should not expect to make a fortune if he or she cannot advocate ample time in a day to analyze the charts and new information. The traders must manage their time in a way that they have ample time to constantly monitor the markets and identify the trade opportunities.

Money management -before the trader ventures into forex markets, he or she should decide the amount of funds he or she is willing to risk. While considering this, the traders should remember that the most successful traders will not put more than two percent of the capital at risk in one trade. Either way, the trader has to brace him/herself for some losses if they want to be in when the

wins kick off.

Start small -As long as a trader is trying to find his feet in the forex market, he or she should stick to a few stocks preferably 3 per day. It is best if a trader gets really good at a few trades than be average at all the stocks and yet make no money.

Education -In a strategy trader should ensure that he or she incorporates education moves. Understanding the intricacies of the market is not all one needs to stay winning, a trader had to stay informed and updated. Any market news and events that might affect the assets should be well analyzed, for example, economic policies shifts. There are many resources and materials that keep one in the know.

Timing- the forex market gets volatile most during the opening hours each day and experienced traders may be able to analyze the patterns and profits. However, it is advisable that one does not make a move during the first 15 minutes even when the odds appear to be good, the trader should stick to his or her time.

Components that everyday trading strategy needs

There are three essential components that must be accounted for; liquidity, volatility, and volume. Day trading involves making money on small movements of prices; therefore, choosing the appropriate stock is very vital.

- **Liquidity-** enables one to enter and exit the trade quickly at stable and attractive prices.
- **Volatility-** informs the trader of his or her potential profit range. A higher volatility means the greater the chances of making profits. However, high volatility also increases losses.
- **Volume-** is the indicator of the number of times an item has been traded within a set timeframe. For the day traders, this volume is referred to as the daily trading volume. High volumes indicate that there is a significant profit in the asset. Increases in volume normally indicate that a price jump (up or down) is coming fast.

Day trading strategies

i) Scalping

Scalping is one of the most popular strategies of day trading in the forex market. This strategy capitalizes on minute price changes. The power behind scalping is quantity. The traders using this strategy to sell once they identify a profit in the trade. Although this is a fast and exiting strategy of trading, there are a lot of risks involved because of the high trading probability required. The strategy has a low risk-reward ratio; therefore, the trader must have a high trading probability to even out. As such the trader should look out for attractive liquidity, volatile instruments and be very hot with timing. One cannot wait on the market and they need to close a losing position as soon as possible. Scalping strategy is by far the most profitable strategy that one may apply when well mastered but the adjacent risks prevent it from being the best in the market.

ii) Momentum

Momentum is a crafty trading strategy most popular among the beginner traders. The actions involve acting on sources of news and spotting substantial trend moves that are supported by volume. On a daily basis, there must be at least one stock that will move around 20- 30 percent, therefore, presenting an ample opportunity. The trader simply holds his or her position until the moment he or she spots a reversal then closes out.

The other option involves fading the price drop; that is, round the price target immediately the volume starts to diminish. The above strategy is effective and simple when used correctly. However, a trader must ensure that they know the upcoming news and announcements about earnings. A few seconds on the trade makes all the difference to the end of day profits.

Reversal strategy

Reversal trading is used by traders across the world but it is potentially dangerous and hotly debated when applied by beginner traders. Reversal strategy is also referred to as trend trading mean reversion trading or pull back trending.

Reversal requires the trader to go against the trend, therefore, defy the logic f trading. As such, the trader must be very good at identifying possible pullbacks and also predicting their strength. To achieve this, one must have in depth understanding and

experience about the market.

Pivot points

The pivot point strategy in day trading is very handy for spotting and acting on the crucial support or resistance levels. Range bound traders can also use this strategy to identify the entry and exit points. Breakout and trend traders can use these points collocate the levels that must break so that a move can be counted as a breakout

How to calculate a pivot point

In forex trade, a pivot point refers to a point of rotation. A trader uses the closing price for trade combined with the high and low of the previous day to get the pivot point. However, it is important to note that if omen uses the price information based on a relatively short timeframe to calculate the points, he or she reduces the accuracy.

The pivot point = (high *low* close)/ 3

With the pivot point, one can easily calculate the support and resistance levels using the following formulas;

First resistance = (2* pivot point) - low

FIRST SUPPORT = (2* pivot point) - high

One can then calculate the second level of resistance and support as follows

Second resistance = pivot point (p) + (first resistance – first support)

Second support = pivot point- first resistance – first support)

Application of pivot point

When a trader is applying the pivot pointy strategy in the forex, he or she will find that in most cases, the trading range for sessions takes place between the first support and resistance levels and the pivot point. The reason behind this is that a high number of traders prefer to play within this range

Traders should also note that this method can be utilized in indexes too. For instance, one can use it to create a viable S& P day trading strategy.

Breakout strategy

The breakout strategy is centered on the times when the price clears a certain level on the chart, with higher volumes. The traders using this strategy enter into long positions once the security breaks above the resistance. They Maya also do the opposite which is entering a short position when the security breaks below support.

Breakout entry point

The entry points in the breakout strategy are straight forward and nice. The prices set above the resistance level require a trader to take a bearish position while that set below the support level requires a bullish position.

Breakout exit point

The exit point requires planning. First, a trader should use the recent performance of the asses to identify a reasonable price target. When using a chart pattern, the process will be more accurate. To create a target, a trader can calculate the price swings that occurred recently. A sensible target can include one where the price swing is three points over the past several swings. Once the trader reaches the target, he or she may exit the trade and celebrate the profits.

Limit loses

Day trading is often said to be the swiftest method of making profits in the forex market but in many cases, the advisers fail to tell the traders that it is probably the most difficult trade strategy that one can master. Consequently, the people who are not well advised try to trade and fail. In all strategies, the trader should ensure that he or she limits losses especially if they are using margin. The requirements for day traders using margin are usually higher and when one trades on margin, he or she increases vulnerability in case of sharp movements of prices. Remember that although the margin increases the chances of great profits, it also magnifies losses. In all strategies, the trader should employ stop loss. By nature, Forex strategies are risky because one needs to accumulate profits in a very limited span of time.

Swing Trades vs. Day Trading

Swing trading and day trading appear similar in some respects. The main factor setting the two techniques apart is the holding position time. While swing traders may hold stocks overnight to several weeks, day trades close within minutes or before the close of the market.

Day traders do not hold their positions overnight. This often means they avoid subjecting their positions to risks resulting from news announcements. Their more frequent trading results in higher transaction costs, which can substantially decrease their profits. They often trade with leverage in order to maximize profits from small price changes.

Swing traders are subjected to the unpredictability of overnight risks that may result in significant price movements. Swing traders can check their positions periodically and take action when critical points are reached. Unlike day trading, swing trading does not require constant monitoring, since the trades last for several days or weeks.

While it may seem safer to open and close a trade in the same working day, day trading is not without risks. Fees and commissions can add up quickly when trading that often. A few bad trades in a day will have a big impact on profit – a day of bad trades can wipe out your portfolio. Swing trading also carries its fair share of risk, but trading is more spread out, and there may be days with few, if any, transactions to pay commission on. Day trading can also be a very high-pressure strategy, given the intense focus and fast thinking needed to manage many different positions at the same time. Swing traders have a little more time to monitor markets and consider trades.

Chapter 3:
Platforms for Swing Trading

Normally, foreign exchange involves selling and purchasing of different currencies across the world. The number of participants in this market is very large therefore the liquidity is very high. The most unique aspect of the forex trade is that individual traders can compete against large institutions such as hedge funds and commercial banks; all one needs to do is to select the right account and set it up.

There are different types of accounts but the traders have three main options namely mini accounts, standard accounts, and managed accounts. Each account has its own advantages and disadvantages. The type of account that one opts for depends on factors such as the size of initial capital, risk tolerance levels, and the hours one has to analyze the charts either daily or at different intervals.

Mini Trading Accounts

Simply put, a mini account is one that allows the trader to transact using mini lots. For most brokerage firms, one mini lot equals to 10,000 units. That is equal to 1/10 of a standard account. Brokerage firms offer mini lots to attract new traders who are still hesitant to trade with bigger accounts or those who do not have the investment funds required.

The advantages of Mini accounts include low risk, low capital required and flexibility. The trader can trade in increments of 10,000 units therefore if he or she is inexperienced, he or she does not have to worry about blowing through their account and capital. Experienced traders can use the mini accounts to test new strategies without excessive risk. A mini account can be opened with as little as $100, $250 or $500 and the leverage can go up to 400:1. A risk management plan is the key to successful trading and in the case of selecting lots; a trader can minimize the risk by buying a number of mini lots to minimize risk. Remember that one standard lot is equal to about 10 mini lots and diversification reduces risk.

The main disadvantage of mini accounts is low reward. A lower risk translates to a lower reward. A mini lot account can only produce

$1 per pip movement if it is trading 10000 lots. In a standard account, one pip movement equals to $10.

A subset of the mini account is the micro account which is offered by some online broker. This account has very little risk and also very little reward. The trade is 1000 base currency units and one pip movement earns or loses 10 cents. These accounts are best suited for traders who have very little knowledge about forex trade and one can open using as little as 25 dollars.

Standard Trading Accounts

The standard trading accounts are the most common for traders especially the experienced ones. These accounts give a trader access to lots of currency worth 100,000 units each. This, however, does not mean that a trader has to put $100,000 in the account as capital so as to trade. The rules of leverage and margin mean that all a trader need is $1000 to have a margin account.

The main advantage of this account is the large reward that one might reap with the right strategy and predictions. One pip movement earns $ 10. Again, individuals who own such accounts get better services and perks because of the upfront capital invested in the account.

The disadvantages include high initial capital and potential for loss. The kind of capital required to set up a standard account can deter many traders from venturing in it. Again, the higher the risk, the higher the returns and the vice versa holds, A standard account trader has a higher risk of loss because if a lot falls with 100 pips, he or she loses $1000. Such loses can be devastating for beginner traders.

Managed Trading Accounts

Managed accounts are accounts where one puts in the capital but does not make the decisions to sell or buy. Such accounts are handled by account managers such as stockbrokers and stock managers. In this case, the traders set objectives for the managers (the expected returns, risk management) and the managers have to meet them.

Managed accounts are categorized into two major types namely

Pooled funds and Individual accounts. In pooled funds, the money of different investors is put into an investment vehicle referred to as mutual fund and the profits generated are shared. The accounts are further classified by risk tolerance. If a trader is looking for higher returns, he or she may put his money in a high risk/reward account while those looking for long term steady income can invest in lower risk accounts. Under managed accounts, the individual accounts are managed by a broker each in its own capacity, unlike the pooled funds where the manager uses all the money together.

The main advantage of managed accounts is that one gets professional advice and guidance. An experienced professional forex account manager will be making the decisions and this is a benefit that one can use. Again, a trader gets to trade without having to spend hours analyzing the charts and watching for developments.

One disadvantage that deters traders from venturing into this account is the high price. One should be aware that the majority of managed accounts require one to put in at least $2000 in the pooled account and $10000 for the individual accounts. To add to this cost, the managers are entitled to a commission which is calculated monthly or yearly. The managed accounts are also very inflexible for the trader. If he or she sees an opportunity to trade, he or she will not be able to make a move but will rely on the manager to decide.

Note

It is advisable for a swing trader to use the demo accounts offered by brokers before investing in real money regardless of the account he or she opts to use. Demo accounts allow one to practice without risk and also to try out different strategies. One rule that every trader should apply is to never invest in a real account unless they are completely satisfied with it. One of the main differences between success and failure in forex exchange is the account selected.

Opening an Account

Forex exchange has been around for very many years and some say that it is as old as the invention of national currencies. Over the

years, the market has grown so much so that it is the biggest market across the world. However, it has not been accessible to the public as easily as it is today. From the 1990s when the era of the internet begun, many retail forex brokers have established routes through which anyone can trade in currencies so long as they can access the internet and have some money. There is a lot of hype and information about forex trade on the internet but not everybody understands how to select and open an account.

Currently, opening a forex account has become as easy as opening a bank account or another type of brokerage account. Some of the typical requirements are a name, phone number, address, email, a password, account currency type, country of citizenship, date of birth, employment status, and tax id or Social security number. Opening an account may also require one to answer some financial questions such as their net worth, annual income, trading objectives, and trading experience. Before one starts to trade on the foreign exchange market, they should make some considerations to ensure that they have a positive, secure and successful experience.

The Right Broker

The first step to trading well is to find the right broker. The activities of forex exchange are decentralized and there are hardly any regulations. Because of the over the counter nature, traders are advised to identify a reliable broker. This involves conducting researches on the reputation of the broker; to identify if there is a history of irregular practices. One may also want to comprehensively understand the services offered by the particular broker before setting up an account. While some brokerages support basic and plain vanilla activities, others offer very sophisticated trading platforms. Some brokers will offer the trader analytical resources to support better decision making while others won't.

Again, a trader should assess the fees and commissions for different brokers. Majority of Brokers charge some fees for their services through the bid-ask spread and in many cases, it is not a large percentage. However, some brokerages have some other fees and commissions and they might be hidden from the trader. When one is considering the extra costs, he or she should check if it is worthwhile.

The Procedure

Opening a foreign exchange account is not hard but traders should have a few things to get started. The trader will have to provide some identification information such as name, phone number, country of origin et cetera. Besides, the trader will be required to state his or her trade intentions and their level of knowledge and experience in the trade. The steps of opening an account may vary depending on the brokerage firm but normally it involves:

- Accessing the website of the broker and study the accounts available. The accounts include small ones where the trader can trade with minimum capital such as mini accounts or the sophisticated accounts designed for experienced traders such as standard trading account.
- Completing an application form,
- Getting registered (user name and password) to access the account.
- Log in to the client portal and arrange for a transfer of money from the bank to the forex account. These deposits can be done through credit or debit card, checks, or electronic transfers.
- Once the funds are transferred, the trader is ready to start trading. Before trading, the trader may review the recommendations made by the brokers or extra services offered such as simulator programs.

Online Trading

It refers to buying and selling stocks or other assets by the use of a broker's internet-based website or trading platform. Currencies, futures, options, ETFs, mutual funds, bonds, and stocks can all be traded online. It is called self-directed investing or e-trading.

As mentioned above, in a split of a second you can trade stocks and other financial instruments such as the Dollar or Euro, some commodities such as Gold or Oil as well as main market indices.

One more advantage of online trading is that the improvement in the rate of which trades can be implemented and settled, since there is no demand for paper-based files to be reproduced, registered and entered into a digital format. Once an investor opens a buy position

on the internet, the trade is set in a database that assesses for the very best price by searching all of the marketplace trades that trade the inventory in the investor's currency. The market with the very best price fits the buyer with a vendor and sends the confirmation to the purchaser's agent and the seller's agent. All this process can be achieved within minutes of opening a trade, in comparison to making a telephone call that requires several confirmation steps before the representative can input the purchase.

It is all up to investors or stock traders to do their research about a broker before opening trading accounts with the business. Before an account is opened, the customer will be requested to complete a questionnaire about their investment and financial history to ascertain which sort of trading accounts is acceptable for the customer. On the flip side, an experienced trader who would love to execute various trading strategies will be provided with a margin account where he can purchase, brief, and compose securities such as shares, options, futures, and currencies.

Not all securities are all readily available to be traded on the internet, depending upon your broker. Some agents need you to call them to put a transaction on any shares trading on the pink sheets and choose stocks trading over-the-counter. Additionally, not all agents ease derivatives trading in currencies and commodities throughout their affiliate platforms. Because of this, it is necessary that the dealer knows what a broker offers before registering with the trading platform.

Most online trading classes are centered on instructing marketplace mechanisms and technical evaluation, while others might concentrate on more specific strategies or particular asset classes. Courses may offer a comprehensive summary of technical analysis in addition to other strategies designed for specific asset classes. They assist traders quickly reach a stage where they are comfortable creating approaches and executing trades.

Chapter 4:
What Makes a Successful Swing Trader?

When it comes to trading strategies, conventional wisdom says that patience is rewarded. Buy a stock, hold it for years and years, and your long-term "buy and hold" strategy will pay off in multiples. But if you are a speculative trader, committed to riding the swings of the market, buy and hold is not really your thing, and conventional wisdom will not be much help. Making money through short-term strategies is hard, but we're here to help. We've got three hot tips to help you become a successful swing trader.

Become a swing trading expert

So what is swing trading? Swing trading is a speculative trading strategy that stakes out the territory between day trading and buy and hold. Skilled swing traders learn to identify the conditions where prices are likely to move either upward or downward in a short period of time, usually between three and 15 trading periods. The goal is to become adept at entering the market just before a multiday swing occurs. But the knowledge required to successfully execute a swing trading strategy goes beyond that of the adrenaline-fueled desk-jockey day trader. You need to familiarize yourself with arcane statistical anomalies in stock movements, and extrapolate those anomalies into multiday runs. You should read pieces from experts such as Trading Strategy Guides (linked above) thoroughly. If you are used to short-term trading or long-term holds, you do not want to get burned by jumping into a trading strategy that you are not knowledgeable about.

Follow the yellow-brick bands

The financial analyst John Bollinger developed a formulaic method for analyzing the volatility of a financial instrument or commodity in the 1980s that has been a favorite of swing traders ever since: the much-beloved Bollinger Bands. All assets have a central moving average, traceable as a line on a graph, which is just a series of averages of all a subset of an asset's high and low points for a designated period of time. To create the Bollinger Band, traders then plot two other moving averages onto the graph of the asset's performance, each one two standard deviations away from the central moving average. When an asset's price touches the upper or

lower Bollinger Band; it means that it has moved into either overbought or oversold territory, respectively. The price is likely to sink or rise over the next few days after the price breaks out of the band. By learning these statistical methods, you can learn to recognize, and profit, from these patterns.

Diversify your time frames

As we mentioned, swing trading hits the sweet spot between day trading and buy and hold. For this reason, no designated period of time exists when you should make trades, or buy or sell. Just as you want to hold a diverse portfolio of stocks to protect yourself from market shocks to one particular sector, you want to have a few different strategies to insulate yourself from daily, weekly, monthly, and yearly market trends. Diversifying your time frames also diversifies the number of trading opportunities available to you. For example, you may want to dip your toe into the Foreign Exchange Markets (Forex), which tend to fluctuate according to the schedules of states, governments, and time zones. You may keep a weekly strategy (and record of Forex volatility) for Forex markets, and a monthly strategy for the US stock market, which will keep your money safer. Forex markets tend to be particularly volatile, which suits swing traders: The greater the number of swings, the greater the number of opportunities to place a swing trade. Still, navigating such volatility requires a combination of skill and luck.

Common mistakes to avoid

The stock market or foreign exchange market has minimal barriers to entry making it one of the most available day trading markets. If you own a computer, have an internet connection, and some money you can begin investing in stocks for the long term or even practice swing trading. Before you start investing in the stock market, you should consider the following common mistakes. Common mistakes such as trading without a stop loss and risking more than you can afford to lose are the main reasons new swing traders fail.

a. Do not keep trading if you keep losing

It is necessary to keep an eye on your risk/reward ratio and win-rate. Win-rate is the number of times you win expressed in percentage form. For example, if you win 100 trades out of 200,

your win-rate is 50 percent. A day trader must have the winning-rate maintained above 50 percent to be profitable in the long run.

Your risk/reward ratio is the amount of money you win compared to the amount of money you lose on an average stock trade. For example, if your average losing trades amount to 60$ and your winning trades amount to $ 180, your reward/risk ratio is $180/60 = 3.00$

A good swing trader should have a risk/reward ratio of 1.25 and above. It is possible to make profits if your win-rate is lower and your reward/risk is somehow high or if your reward/risk rate is more economical, but your win-rate is higher. You should use the best trading strategy that works for you. A good trading strategy wins more than 50 percent of the time and gives a reward/risk of at least 1.25.

b. Avoid trading without a stop loss

You should always have a stop loss order for every trade that you make. A stop loss is an order that offsets by getting you out of a deal if the price goes against your prediction by a specified amount. A stop loss will help you moderate losses by accepting the loss and moving on to open the next trade using the remaining funds.

c. Trade with what you can afford to lose

The central part of your strategy should be establishing the amount of capital you are willing to lose on every open trade. You should not risk more than 1 percent of your investment on a single trade. That will mean that even if you lose many trades only a small amount of your capital will be lost. Moreover, it also implies that if you make 3 percent profit on every winning trade, your losses are recovered quickly.

You should stop trading if you lose up to 4 percent of your capital on a single day. It is crucial to note that as a trader you must have bad days. Even with a risk management strategy in use, there will be moments when you will be tempted to ignore and take a big trade than what your trading technique requires. The reasons could be because you have had numerous losing trades and you want to win back. Sometimes it may because you are winning all your trades lately and you are very confident that you are willing to risk

all your capital on it.

Learn to stick to the 1 percent risk on each trade and 4 percent or so reward/risk ratio. Risking too much is making a mistake and mistakes tend to compound with time. If your risk does not work out, do not cancel your stop loss hoping that the situation will change in the end. You should avoid such temptations and abide by your risk management strategy.

d. Do not open multiple trades that are correlated

Diversification is vital, but that is arguable. If you believe in diversification, you may open many trades at the same time while thinking that you are reducing your risk. Chances could be that you are increasing the risk especially if the opened trades are correlated. Correlated trades move in the same direction meaning that you may win all trades or lose all. If you must open multiple trades ensure that they are not correlated.

e. Do not trade off economic or fundamental data

It is easy to make a biased trading decision based on news or an article you came across online that promises that economic conditions are good or bad for investment. The long-term outlook is not necessary when day trading. The concern and objective of good traders should always be to implement their strategy irrespective of the direction their trading approach tells them to trade. Paying close attention to fundamental analysis in day trading is not a good idea because fundamentals have no effect on short-term movement in price.

f. Do not try to anticipate news

Many stocks fall or rise sharply during releases of scheduled economic news. Predicting the direction a stock will move and opening a position before the report is released seems an easy way to make huge profits, but it is not. In most cases, the price will move in both directions quickly and sharply before choosing one sustained course.

g. Chasing Performance instead of Rebalancing

Many swing traders select asset classes, managers, funds, and strategies based on past performance. The feeling of missing out on

high returns has resulted in bad investment decisions. If a particular financial instrument has performed exceptionally in the last two or three years, it is a fact that you should have invested in it three years ago. Always rebalance and stick to your investment strategy. Rebalancing is returning your portfolio to its target stock allocation as detailed in your investment plan.

h. Using too much Leverage or Margin

A margin is an act of using borrowed funds to buy securities. While margin can be used to make more money, it can also exaggerate your losses. The worst thing that happens to new swing traders is being carried away with what looks like free funds. If you can buy stocks with your credit card comfortably, then you can risk using margin or leverage. If you use high leverage or margin and your investment does not work, you may end up with massive debt. Besides, using margin requires monitoring of your open positions.

Summary

Swing trading has its pros and cons, but ultimately it is a form of trading that most traders can benefit from trying. It does require an initial time commitment to learn about technical analysis, but well-developed charting software and user-friendly apps make it possible for even less-experienced traders to get a feel for it quite quickly. Swing traders receive feedback on their trades within a short time period, which can also accelerate the learning curve for newer traders. Swing traders can make regular small profits, and as their experience increases, they may well be able to scale up to larger profits.

There are certainly risks involved, as with any trading method, so it is important to have good risk management strategies in place. This method, however, does allow traders to create clear boundaries around their trades and avoid some of the bigger losses that other traders face, as stop losses are generally smaller on short-term trades than for trend traders. Swing trading will not suit everyone, but for many traders, it provides a comfortable ‘happy medium’ between the frantic pace of day trading and the patience and long-term commitment needed for trend trading.

Chapter 5:
Instruments and Strategies Used
for Swing Trading

How Swing Trades Works

Swing trading seeks to capitalize on the upward and downward "swings" in the price of a security. Traders hope to capture small moves within a larger overall trend. Swing traders aim to make a lot of small wins that add up to significant returns. For example, other traders may wait five months to earn a 25 percent profit, while swing traders may earn 5 percent gains weekly and exceed the other trader's gains in the long run.

Most swing traders use daily charts (like 60 minutes, 24 hours, 48 hours, etcetera.) to choose the best entry or exit point. However, some may use shorter time frame charts, such as 4-hour or hourly charts.

Swing Trading Strategies

Swing traders can use the following strategies to look for actionable trading opportunities:

i. Fibonacci retracement

Traders can use a Fibonacci retracement indicator to identify support and resistance levels. Based on this indicator, they can find market reversal opportunities. The Fibonacci retracement levels of 61.8 percent, 38.2 percent, and 23.6 percent are believed to reveal possible reversal levels. A trader might enter a buy trade when the price is in a downward trend and seems to find support at the 61.8 percent retracement level from its previous high.

ii. T-line trading

Traders use the T-line on a chart to make a decision on the best time to enter or exit a trade. When a security closes above the T-line, it shows that the price will continue to rise. When the security closes below the T-line, it implies that the price will continue to fall.

iii. Japanese candlesticks

Most traders prefer using the Japanese candlestick charts since they are easier to understand and interpret. Traders use specific candlestick patterns to identify trading opportunities.

What is an individual share/stock?

If you own a share, it means that you own a portion of an organization. It is the same way you can visualize your ownership of a company as a slice of bread cut out from a loaf of bread. A person who owns shares is known as a shareholder. A shareholder is entitled to receiving cash flows; cash flow is also known as a dividend. Dividends are given by an organization when its board of directors declares that the company has made sufficient profits to distribute to the shareholders. Board of directors also own shares in the company. In most cases, you may find that the board of directors holds a majority of the shares of the company.

Owning a share is important because it gives you the right to cast a vote on the decisions of the organization. A share can also be called stock or equity.

Definition of share price

The share price is the price at which a particular stock can be sold or bought in the market. The value of the share price is influenced by many factors such as supply and demand for a specific organization's shares.

Factors influencing the share/stock price

- If a company has more buyers than sellers of its shares, the share prices will increase because the demand is high. Demand and supply are inversely proportional. That is to say that when the demand is high, the supply is low and vice versa.
- When the sellers are more than buyers for a specific organization's shares, stock prices usually reduce because there are more of these equities available.
- If a company makes a lot of profits, its share will be more valuable because a majority of people believe that investing with the company will yield gains.
- Political and economic factors also affect the price of stocks in the market.

Making a decision on which company to invest

It is advisable for you to research the stock market by reading financial information regularly, seeking an opinion from a qualified expert such as a stockbroker, and attending investment courses.

You can also assess the performance of the company by studying analyst reports and reading the company's financial statements. By doing this, you will have a higher chance of making educated decisions on the companies to invest your hard-earned funds.

Decide on how much risk you are willing to take, the amount of profit you expect, and the investment instruments that meet your requirements. You can consult a qualified expert if you need extra advice.

Have a commitment to your investment objective. Always bear in mind that investing for the long run is advisable. For example, you should have a 5-year investment objective.

Decide on how long you can wait for returns and be patient. If the stock you invest in fails to perform for a year, you may need to change your strategy by choosing another stock. Invest with funds you are willing to lose and that you do not require in the short run. That is, make sure you have disposable funds after taking care of all your daily expenses. You should be aware that investing can help you make additional income, but there is also a risk of losing funds in the short run.

Types of Stocks and other Investment Instruments

There are different types of investment products and shares that may suit your needs. They are categorized into two groups: safe (conservative) shares and risky shares. The following is a list of investment products:

N-Ordinary shares, B-Ordinary shares, Preference shares, Ordinary shares, Exchange Traded Funds

Exchange-traded fund (ETFs)

It is an investment product that is traded on share exchanges just like stocks. ETFs hold assets such as commodities, stocks, and bonds. It operates with an arbitrage technique designed to make it

trade close to its average asset value. However, deviations can occur most of the time.

Options Trading

An option refers to an agreement between two people or parties providing the buyer with the right to sell or buy a security at a certain agreed price on or before an agreed date. To acquire such a right, the buyer pays a premium to the seller or writer of the agreement. Note that the buyer (taker) has the right to buy or sell but no obligation.

The term stock can be used to refer to shares or any underlying securities. When choosing between a stock and an option, the same concepts apply. Options may be available from time to time over other kinds of securities. The standard number of stocks or shares covered by one option agreement on ASX is 100.

Call Options

Call options provide the taker with the right but not the permission to purchase the underlying shares at a specified price on or before a predetermined date.

Call option example

Santos Limited shares sell shares at the last price of $ 8.00. A four-month option would be a four-month $ 8.00 call. A buyer of this contract possesses the right but not the obligation to 100 Santos Limited shares for $ 8.00 for every share or stock at any moment until the expiry date. For this right, the buyer pays a premium or also knows n as the purchase price to the taker or writer of the option. For the taker to take up the right to purchase Santos Limited shares, the taker must exercise the option before the expiry date.

Besides, the writer of the call option is supposed to deliver 100 Santos Limited shares at $ 8.00 per stock or share if the buyer exercises the option. For accepting this obligation, the writer keeps and receives the option premium irrespective of whether the option takes effect or not.

Put Options

Put options provide the taker with the right but not the obligation

to sell the underlying stocks or shares at a given price on or before a specified date. The buyer of a put is required to deliver the underlying stocks if they practice the option. If the option or call is practiced, the shares are traded at the predetermined price. This price is known as the strike or exercise price. The final day when an option can be practiced is called the expiry date.

There are two exercise styles:

European Style- implies that the option can only be practiced on the date of expiration.

American Style- implies that the option can be practiced at any time before the date of expiry. The writer of a call option and taker of a call option do not have to own the underlying stocks.

Advantages of options trading

- Diversification

Options can help you build a diversified portfolio at a lower price than buying stocks directly.

- Leverage

Leverage gives a possibility of making a higher profit from a smaller initial investment as compared to investing leverage-free. Even so, using leverage increases your risks compared to opening a trade using your underlying stocks or shares.

- Speculation

The ease of trading out and in of an option makes it possible for you to trade options without the requirement to exercise them. If you expect a rise in stock prices in the market, you may purchase call options. If you anticipate that the prices may fall, you can buy put options. It is also possible to sell the option before expiry to cut down on losses.

- Generation of Income

You may earn additional income by executing call options against your stocks. Also, call options can be written against shares purchased using a margin lending facility. Writing an option makes

you access the option premium up front. It is essential for you to balance the merits of trading options with the risks before deciding.

The diagram shown below gives a comparison between buying one call option and 100 stocks.

Differences between Futures and Options trading

You may realize that these two trading options always appear as if they are similar, but many studies have shown their distinction in practice. The difference lies in the number of obligations that they put on buyers.

An option allows the buyer to buy or even sell different assets, at any time, and a certain price. It is a right that is always given to purchase a stock at the strike price, but it must be conducted before the expiry date, or on the expiry date of the agreement. Option buyers are not limited because sometimes the prices go up and favor them.

Future trading allows buyers to buy assets and sellers to sell assets and take them to designated persons but in the future date. In short, futures and options are written buying and selling agreements between two parties. A future is an obligation that is given to buyers.

Bonds

A bond is an interest-earning debt financial instrument issued by a government. The redemption period for government bonds is usually one or more years after issuance.

Higher risk securities are listed below:

- Warrants
- Shares
- Corporate bonds, and
- Derivatives

Stock investment is riskier than some other investments. The main reason for this is because stock prices fall and rise all the time due to political and economic factors that affect the market forces. However, the higher the risk involved the greater the possibility of making profits. Usually, higher risk means a higher return on

investment.

Cryptocurrency

From among, options, CFDs, futures, and Crypto investments, Cryptocurrencies are the most recent investment options available in the forex market. Due to the recent foray of cryptocurrencies into online trading, a thorough research is required by swing traders who aspire to make profits from cryptocurrencies.

Crypto Market Place

Just like any stock markets, swing traders prefer reviewing the Cryptocurrency markets every morning although the crypto market is always open every time. Online trading of cryptocurrencies happens 24/7 providing crypto traders with incessant trading opportunities. Along with Bitcoin fluctuations, the alternate coins also change and mostly track Bitcoin price fluctuations. For example, the total market cap that reflects the aggregate of all crypto alternative coins had traded today in the narrow range of around $208 Trillion to $210 Trillion.

In general, the crypto investors focus on top ten cryptocurrencies to begin their journey into cryptocurrency trading. Frequently cited currencies are, Ripple (XRP), Ethereum (ETH), Bitcoin cash (BCH), and Litecoin (LTC). Although, as of August 2018, the number of cryptocurrencies traded in the Crypto market place exceeds 1600-thus offering plenty of opportunities to beginners and experienced crypto investors many opportunities to trade and make investments.

Definition of cryptocurrencies

Cryptocurrencies are digital currencies which can be used to digitally transfer money to another person safely, without having to use intermediaries or trusted third parties, like a bank or Visa, e.g., to verify that you have sent the money and the money is now no longer yours. You might want to read that sentence again, slowly. In addition, it does it much faster at a fraction of the cost because it does away with unnecessary and expensive transaction fees.

The way digital currencies provide safety is two-fold. The first is that it uses Encryption technology (hence the name cryptocurrency).

Definition of block chain

The second way is to have a public ledger, where all the transactions are kept. Thousands of computers around the world are linked together to display this ledger. They refresh and update every few minutes. This network of computers all linked together in this way is called the block chain. You can trust it because it means that each transaction has been verified again and again by all the computers (the block chain). With thousands of computers linked up all over the world saying the same thing, the ledger's integrity is upheld. Each cryptocurrency can have its own block chain, although some are shared.

How it works

Imagine I send you 10 dollars and you send the 10 dollars to someone else. Somehow someone has to keep track of these transactions, to avoid forgeries or anyone claiming they have not received the money. In the past, Central Banks or banks have kept details of the transaction on something called a ledger. This is based on a centralized system. With Bitcoin, currently the main digital currency, the whole system was turned on its head. Instead of a centralized system controlling the ledger, now thousands of computers, all around the world, each keep a copy of this Ledger.

Every single transaction is kept there, from the beginning to present day. This is a decentralized system, called the 'block chain'.

Please note that money in itself does not have any intrinsic value-it is only because we believe that it has value that it is worth anything. Money is just a tracking system-we track what we own and what we owe. This is called a ledger. Whatever form of money exists, we give it value because of its utility as a ledger (or tracking system of who owes what). That's what the block chain is-a giant decentralized ledger.

The idea comes from airplane safety. If you have one computer flying the plane and the system crashes, the airplane could crash. The thought was that if there were three computers, and one crashed, then the fact that two computers were saying something different to one meant that the two outweighed the one and the plane would continue even if one crashed.

The inventors of the block chain took it one step further and

wanted as many computers as possible to be in on it. So if there is a disagreement on a few computers of the block chain, whatever the majority. For example, 51 percent are saying will win and that information is put on the ledger on all the computers. A particularly brilliant analogy for this comes from Nick Szabo, the inventor of BitGold, which many view as the precursor of Bitcoin. Imagine a fly trapped in amber. If there is only a small layer of amber, we know that the fly has not been trapped for very long. But if there is a big block of amber, we know that the fly has been trapped for a long time-no one can dispute that.

Dash

I only have one position which is up by 6 percent. This is one I wish I had more of. I am looking for any weakness in the dollar price to get in again.

Litecoin

When the currency was first launched, it aspired to be the 'silver' to Bitcoin's 'gold'. One of the biggest advantages that Litecoin possesses is it can handle a higher volume of transactions thanks to its algorithm. The faster block time also prevents double spending attacks. 32 While Litecoin failed to secure and maintain its second place after Bitcoin, it is still actively mined and traded and is bought by investors as a backup in case Bitcoin fails. Do I own Litecoin? This is an interesting one because it has a lot of promise but it just doesn't seem to be going in the right direction. If it doesn't do something soon it might be overtaken by some of the promising new coins like Dash. I hold one position which at time of writing is up by 12 percent.

Where is the value of Bitcoin and other cryptocurrencies?

Some people call Bitcoin and the block chain 'Internet 3.0'. We understand why they may see it in this way; however, we have to be clear that Bitcoin is a different technology to the Internet. Bitcoin and Ethereum are called a 'Fat Protocol'. For the Internet 'HTTP' is a protocol that defines how information is sent over the Internet. On the back of these protocols, programmers built application like Facebook and Google. While these protocols created an enormous value, most of the value was captured by the

applications that were built on top of the internet. The people who created HTTP did not make money and are relatively unknown. However, the owners of Facebook and Google became billionaires and are celebrated entrepreneurs.

With Bitcoin and a platform like Ethereum, it is the actual network itself that is generating the value. Token holders are the ones who are going to benefit. The value will be captured by those building and investing at the block chain protocol layer because of the financial incentives (tokens) that are part of the network's design. Participants of the network (users, developers, investors, etcetera) are incentivized to grow the block chain network because as the network expands the tokens are going to be worth more.

Determination of prices

A. The value of cryptocurrencies are dependent on the market, where the prices of various cryptocurrencies vary a lot and it is one of the most fluctuating and volatile markets to date.

B. The price of cryptocurrencies, like any other products, is dependent on demand and supply. If more people demand a particular currency and it is short in supply, then the value increases. More units are mined by miners to balance the flow. However, most currencies limit the supply of their tokens.

C. Scarcity is an important factor when compared to fiat currencies. Fiat currencies can be printed every day, making our money worth less every year. Digital currencies, however, have limited supply. For instance, the total amount of Bitcoin issued is only 21 million. Therefore, Bitcoin's supply will decrease in time and will reach its final number by 2140. It also explains why Bitcoin's value is higher compared to other cryptocurrencies. Dash has the same idea, limiting itself to 18.9 million-this might explain why its price is also doing well.

D. Trust. This one is often overlooked but, like with any currency, tokens will only have value if people have trust in it. Trust comes from a lot of sources such as the credibility of the developers and the kind of service provided.

The Price of Bitcoin

Well, this is the 64 million dollar question, is not it? A client of mine and I came up with quasi the same potential possible future valuation = $100,000 per Bitcoin. This is how we calculated it-it is not very scientific. If Bitcoin really is Liquid Gold and so becomes the new 'Golden Standard' as a store of value, then you have to figure out the current value of all the Gold in the world that has been mined. If that is valued at approximately 8 trillion dollars and if Bitcoin reaches that same level and there are only 21 million Bitcoins ever mined, then that would mean $400,000 per Bitcoin.

Important here is the scarcity factors – if that ever changed and more were created, then all bets are off. A multi-millionaire investor friend of mine once told me a long time ago that if you talk to a startup founder and they say their business is going to make x profits in y time, and it would take z costs to do it, then it will probably be half the amount of profits, take double the amount of time and cost double the amount. I have very much taken this to heart throughout my investing career. Therefore, on a potential valuation of $400,000 I would halve it and halve it again. That's how I came up with a potential number of $100,000. I told you, not very scientific.

It still leaves Bitcoin with a lot of upside. I just don't know how long it will take. It is going to take longer than you think. If you feel this valuation is not big enough, then there are others who believe Bitcoin could go to $1 million valuation per Bitcoin. That's a dangerous 37 thing to say because I think due to its scarcity it will go up but I don't know WHEN. There are a few things that could act as a catalyst. China has banned Bitcoin before and unbanned it If it were to unban again then prices would explode Also when leverage comes in prices will explode.

How to make money with cryptocurrencies

There are many ways to make money with cryptocurrencies. The four most popular ones are:

1. You can mine them

This is where you use your computer(s) to mine for Bitcoin i.e. use the computational power of your computer(s) to help verify certain transactions on the block chain and be rewarded with Bitcoin or other coins. In my opinion there is not much money in it for the average person.

2. You can lend them

This is where traders who need margin and leverage borrow your coins to trade with. They have to give them back to you with a percent commission.

3. You can buy already established cryptocurrencies

4. You can buy new ICOs

Recently there have been flurries of new Initial Coin Offerings where, if you get it right, you can invest £1,000 and turn it into £10,000 or even £100,000 in a relatively short period of time. Therefore, we will also be discussing this topic. When choosing cryptocurrencies, do your research; don't get caught up in the hype. When you are researching, remember to ask: 1. "What problem is it solving?" If it doesn't solve a problem then why would anyone use it or buy it?

Bitcoin and Ethereum are the most widespread by far. Imagine them like the Reserve Currency of the crypto world-if you wanted to invest in other cryptos, then you have to buy Bitcoin or Ethereum with your local currency first. Then you buy the other cryptocurrencies with your Bitcoin or Ethereum.

If you don't want to buy the cryptocurrencies themselves, you can always buy a Bitcoin fund or Bitcoin tracker. I did this for my daughter in her Junior ISA and it went up 98 percent, making her just under £2,000 in just three months. This might not seem like a lot of money but £2,000 in three months is not bad for an eight year old!

What are the signs of a 'bad' cryptocurrency?

Avoid these signs of a bad cryptocurrency

1) Me -too coins-these are coins that do exactly the same as already existing coins and don't really add any more benefits or USPs. They are just copying what has already been done. Avoid these. If, however, they are sufficiently different and do the same but do it in a much better or faster or cheaper way etc. then it might be worth considering.

2) Coins for specific industries -what I mean by this is coins that

are designed for just one market. A perfect example is Potcoin. I actually bought some but I regret it now because all they are saying is “here is a market and we are going to create a coin for this market so everyone can use this coin to buy marijuana.” But in reality there is no real need for this coin. It doesn’t solve any problems. You can use Bitcoin or Monero or Ethereum instead. Worse still, there are other coins like Dopecoin, Cannabiscoin, and Hempcoin doing the same thing. Paragon, on the other hand, is creating a platform for the Marijuana industry-I own tokens in Paragon too.

3) Teams that are either too small or unqualified- in reality it is not easy to make a startup successful, or the competition is only going to intensify. It is best to check out the backgrounds of the team and see if they really do have the experience to pull off what they are suggesting in their whitepaper. Also, the team needs to be large enough to handle this or at least they have to have plans to hire more relevant team members. A one-man band or three people can’t dominate an industry.

4) Low trading volume -it means that that not enough people are buying and selling. This is not a good sign. You want to see ever-increasing volume as the market is waking up to the opportunity. If you take care of the above then you should avoid the majority of coins that are scams.

How to start buying Bitcoins, Ethereum and other Altcoins

Generally, you have to buy Bitcoin or Ethereum with your fiat money first. Then you can buy other Altcoins with Bitcoin or Ethereum. There are two ways of buying Bitcoin through an Exchange or Direct.

1. Exchanges

a. Fiat exchange

Cryptocurrency exchanges are websites which allow you to buy, sell and exchange cryptocurrencies for other digital currencies or fiat currencies like USD or Euro. Kraken is one of the largest. When I started I used Gemini. The exchanges require you to open an account and verify your identification. Once you have exchanged fiat for Bitcoins, you can then either buy other coins, or in the case

of Gemini, you have to then send your Bitcoins to Coin exchanges, like Poloniex, Bittrex or Coinbase.

b. Coin Exchange

These are websites that connects buyers and sellers where they charge certain fees for a completed transaction.

i. Reputation

ii. Fees-they may vary according to the exchange you choose.

iii. Payment Methods

iv. Verification Requirements

v. Exchange Rate

c. Examples of Coin Exchanges

i. Poloniex: this is the first one I ever used.

ii. Bittrex: this is the second one I opened. Bittrex has one of the most numbers of coins to trade, that's why I like it so much.

iii. Kraken: The third one I opened was Kraken. It is one of the largest exchanges in Europe. Now that it no longer accepts GBP I don't find it as useful, however our Continental friends can still use it to send their Euros and purchase Bitcoin. Since the selection of other coins are limited however, unless you are thinking of just holding Bitcoin, Ethereum and some of the other larger coins, you will probably be sending your money to exchanges such as Bittrex or Poloniex.

iv. Coinbase: this is the best known. No idea why I have not used it but I have not. Actually, while writing this book I realized that I probably should open an account with Coinbase and have even made a video on how to open the account for the members of our Crypto Club.

Note: Opening these accounts is simple but it is not easy. We are at the beginning of a new technology here. Things are getting better but as a beginner it might seem very convoluted at first, some might say downright confusing. This is a good thing. It keeps the masses away while you and I get our positions. Once the doors open,

everyone will want to get in. We will be in a great position once that happens. So be grateful that it is not easy to open an account, otherwise everyone would be doing it right now.

2. Direct

One of my friends used LocalBitcoins website to exchange GBP into Bitcoin (BTC). “I found a seller selling BTC at a predetermined price, got myself verified as per their instructions and then made a bank transfer to them. The BTC were held in escrow until payment was received. As soon as the payment has been confirmed the BTC are released. I then transferred my BTC from the site into an exchange.”

As always, please remember to do your own research and due diligence.

Strategies to use

Once you have opened up your account, you can start to invest in the coins. All you need now is a strategy. Most people do not have a strategy which they have thought about in advance, written down and then follow to the letter. That is the biggest mistake of all. Before we start getting into the strategy, here are a few other mistakes you should try to avoid at all costs:

Mistake One: Investing in something they don’t really understand or believe in long term. Therefore, you are too easily tempted to sell if the price begins to fall in the short term. To counteract this mistake, start by sticking to the major ones in terms of market capitalization. For instance, the top ten for safety first while you test the market.

If you want something a little bit more advanced with more gadgets but that basically does the same thing, then try Coingecko website.

Some people prefer Coingecko because it has its own rating system that takes more information into consideration before ranking, whereas Coinmarketcap only uses the market capitalization to rank it. It is up to you which one you want to use but Coingecko does have more functionality.

Mistake Two: You may think you have missed the boat on the most successful cryptocurrencies, whose price has run up-think Bitcoin

and Ethereum-and so invest in less established, smaller and more speculative coins just because the price is much cheaper than that of Bitcoin and so have more of an upside. While you can put a small 10 percent of your money into speculation, the majority of your money needs to go into any of the pull-backs that occur on the more established cryptocurrencies. A pull-back is a fall in price significant enough for you to enter. For example, a pullback of 10 percent from the recent high is perfect.

Mistake Three: You may try to day trade and profit from short term market movements, both up and down. While this can undoubtedly be profitable for someone who knows what they are doing, this is absolutely lethal for anyone who doesn't know proper risk management and who doesn't have a strategy or has a strategy without the proper risk reward ratios. Anyone who doesn't have this is going to get killed by the volatility.

Chapter 6:
How to Swing Trade

Swing trading refers to the longer term trading style which requires a trader to hold his or her trades for a number of days. Unlike the day trading style, this trading style is appropriate for people who cannot monitor their charts for many hours during the day but can spare some time to analyze the market. For example, someone who is fully employed during the day may use a couple of hours at night to study the market. These traders have a tight schedule but they have some time to stay updated with the happenings in the world economy.

Swing trading seeks to identify the swings occurring within a medium-term trend and the trader enters when he or she sees a high chance of winning. For instance, a trader should aim to go long when the swings are low and go short when the swings are high to benefit from the countertrends. Considering that the trades last longer than a day in the swing trade, the trader has to select large stop losses so as to whether volatility. This must be included in the money management plan. There is a possibility that a trader will see trades going against him/her because the price scan fluctuates a lot during the short time frames, A swing trader should remain calm in these timeframes and trust his or her analysis. A swing trader usually has larger targets theretofore the spread price does not have a lot of impact on the overall profits. Consequently, trading pairs with lower liquidity and larger spreads are acceptable.

One may participate in the Swing trade if he/she; does not mind holding the trades for a number of days, is willing to make more careful decisions based on thorough analysis and selecting only a few trades at any one time, is very patient, does not mind large stop losses, and is able to remain calm when the trades go against the expectation. If one likes action packed and fast paced trading, is impatient and wants immediate results, cannot spend time doing a thorough analysis of the charts, then he or she should avoid swing trades.

Swing traders analyze the swings which consist of two parts; the swing point and the body. The swing point is the point at which the trend starts moving in the opposite direction while the body is the

bend between one swing point and the next. The trader has a task of timing his or her entry in a way that facilitates the catching of a majority of the body.

Catching a swing point can be very lucrative but it is not compulsory. In fact, a trader might lose more while trying to catch the extreme swing points on the top and the bottom. One good way of approaching swing trade involves waiting patiently for a signal to buy or sell. In any market move, the swing body is the most profitable part.

Comparison between day trading and swing trading

Both swing and day trades do not rely so much on the commodities that one wishes to trade in, for instance, oil and stocks, rather it all a matter of time. Consequently, the day trader will be interested in the changes within the day for example at four hours intervals while the swing trader will pay more attention to multiday charts and patterns. Some of the patterns that the swing trader will watch include head and shoulder patterns, double bottom, cup and handle patterns, triangles, shooting stars, flags, and moving average crossovers.

Another difference between the day trading and swing trading involves the stop-loss approaches. Stop losses in the swing trading normally wider than the day trading because of the difference in profit targets.

Swing trading is a trading style preferred by many retail traders because firstly, they contain entry and exit strategies that do not require one to keep checking the charts every few minutes or hours and secondly, it is a long term strategy. The trading style is well suited for people with busy lives or even full-time jobs, therefore, cannot afford to watch the charts every other minute.

Traders that use the swing trading technique may use timeframes on the charts from as low as 5 minutes to an hour. Swing traders may combine both the fundamental and technical analysis to draw conclusions and make decisions. To a large extent, it does not matter whether the market has a long term trend and/or that the market is range bound because the forex swing trader will not hold the positions long enough for these factors to count.

However, volatility makes significant differences for swing traders because highly volatile markets suit them best. A higher volatility translates to a higher number of movements in the short term. As such, the swing trader has many opportunities to place his or her trade. Swing trading has a number of benefits including benefits from liquidity, sufficient volatility to create trade opportunities and relatively short time frames to make earnings.

Some swing traders find the extremely short term trades exhausting because of the amount of time spent monitoring. They also find long term trading too boring and not active enough with too much demand for patience. As such, they settle for swing trading because it is simpler to use and has friendly time frames. Beginners also prefer this type of trading and try it out with demo accounts before getting into the real business.

In swing trading, there are certain techniques and strategies that work well together to get the trader a win. Remember that swing trading is not just a trading style but also a strategy. Within this style, there are different strategies that a trader can use to swing trade safely. Keep in mind that swing trade operates over medium and short timeframes; that is between the day trading which requires a very short timeframe and the positioning trading which requires a very long term. The thing is, swing trading is short enough to create plenty of opportunities for traders but not so short that the trader has to stay glued to the charts. The following strategies are not strictly for swing trading, unlike other technical strategies.

Main concepts behind swing trade strategies are resistance and support. The concepts allow one to choose between two decisions; either follow the trend or go against the trend. The counter-trend strategies seek to make profits when the levels of resistance and support hold up. On the other hand, trend following strategies identify periods where the levels of resistance and support break down. In both cases, it is important that a trader has the ability to recognize a price action visually. Remember that markets do not follow a straight line. Even when the markets are trending ultimately, they tend to move in step like movements of up and down. When the market sets a higher high, traders recognize and uptrend and when the market sets a lower low, then the traders recognize a downtrend. As such, most of the swing trade strategies seek to catch and follow a short term trend. In other words, a swing trader will be looking for a trend, then he or she will wait for a

countertrend and after the trend has played out, he or she enters the market.

Trend trading

Trend trading is identified as one of the simplest and most natural ways or profiting in the retail market. The difficulty with trend trading is that there are a lot of misconceptions surrounding it. This is as a result of the misapplication of analysis methods that are intended for stocks and other commodities. Currency pairs in the forex market tend to move at a lower speed than other commodities and stocks and as such, applying traditional trend breakout strategies without discrimination will result in losses in due time.

Traders who apply swing trading are normally looking to close out the winning trades in one or a few days after the initial transaction. This poses a challenge when one tries to apply a trend trading strategy to the short time frame because the trend trading profits are generated from the big winners after they are allowed to run.

Traders should know that the forex market spends more time in ranging than trending. Even in those cases where the markets are trending, they still range to some extent within the trend with many retracements. Ranging is referred to as “mean-reverting” in technical terms and this signifies that the prices tend to range back to the average. (Revert to the mean).

Candlestick trading

Majority of the beginner traders are advised to look for particular candlestick formations that align with resistance and support. This style dictates that one has to be very careful and selective about the trade he or she picks and to stick to the sidelines until everything looks perfect. This style has a chance of making profits but many people find it hard to make more than just a small margin of profit. There are a number of reasons why people do not make a lot of profit with this style. First, it is very hard to find a set up that looks perfect therefore the traders will let many opportunities go. Secondly, the style has very difficult effects on the psychology of the trader because he or she has to sit on the side and watch an otherwise good move get lost. Consequently, the trader might get itchy fingers in the trade and dive in too deep. Thirdly, when used on its own, candlestick analysis is almost useless. It is used in combination with resistance, support, time of the day, trend and other factors. All the mentioned factors are more powerful in themselves than the candlesticks and yet the trader is taught to

focus on the candlestick before any other thing. Another weakness of the Candlestick analysis is that it ignores quantitative and fundamental factors.

Bollinger band strategy

The Bollinger band strategy is defined as the continuation trading strategy that uses the technical indicator called 20-period moving average to identify the trend direction. These bands are good for measuring the volatility of the instrument one is trading and it is used to form a basis of swing trading in the forex market.

The Bollinger bands indicator consists of three lines; lower band, top band, and middle band. When a trader or an analyst is using the Bollinger band settings for the strategy, the three lines represent;

The top line- two standard deviations from the moving average to the upper side

The Middle line is the moving average for 20 periods

The Lower line -two standard deviations from the moving average to the downside (middle line)

A trader may try to change the band setting in search or the perfect settings but there is hardly any such thing, therefore, anyone who tells you that they are selling the best settings is being dishonest.

The theory behind the Bollinger band is that the two bands (lower and upper) contain price action. This means that any price movements touching or exceeding the upper or lower band indicates increased volatility within the market.

The trading rules of Bollinger bands

Technique 1: trading the support and resistance of the band lines

A trader can use the lower and upper bands as resistance and support indicators whereby; if the price touches the lower and upper bands and reverses, indicating the probability of a major move.

Technique 2: trading the fixed horizontal lines combined with the band lines.

In this method, the trader looks for the horizontal resistance and support levels which coincide with the prices that are touching the lower and upper band. The trader should ensure that the price has reversed on this support or resistance level at least once. This makes that trade signal reliable.

Technique 3: Trading the breakout

While trading the breakouts, a trader should watch for the trend process as they break through the lower and upper Bollinger bands. The trader should also ensure that the candlestick is closed above the upper line before entering and that it closes below the lower line before exiting. This technique works best on a trending market.

Technique 4: Trading the squeeze

Firstly, the price must be pushing between the lower and upper bands. Under such circumstances, the market has low volatility. The trader should wait for the breakouts which can either be upwards or downwards. The Bollinger band helps a trader to identify the push and capitalize on the breakout happening afterward. One can place a pending stop order on the two sides' right outside the squeeze. These stop orders will be triggered once the break out happens. When one stop order is activated, the trader may cancel the other one. The trader should then place a stop loss order halfway through the squeeze or on the other side.

Another style of trading with Bollinger band squeeze that a swing trader can use is to wait for the breakout, once it happens, wait for the price to reverse till it touches the middle band, and then enter the order.

Short Selling

Short selling refers to the practice of selling shares that do not belong to the investor. The primary aim is to make profits from a future reduction in the price of the stock. The investor who sells short is called the short-seller and usually expects to purchase back the stock from the market at a lower price than the price it was sold short.

Short selling is not complicated, but many investors have trouble understanding. In summary, numerous people think that investing

is buying an asset and holding it for some time as its value appreciates and selling it eventually at a profit. Shorting is the exact opposite because an investor makes a profit when the cost of a shorted security reduces. Therefore, a short sale is a sale of a security that does not belong to the seller. The security is sold with the expectation that it will be delivered.

Short selling works as described below:

An investor borrows stock from another investor through a broker, sells it and keeps the proceeds of the sale in a brokerage account. After some time, when the price of the stock reduces, the investor purchases the shares from the market and uses them to replace shares borrowed from the broker and then proceeds to close the short position.

The short-seller deposits a specific amount of funds, referred to as the margin, with the broker as security for the short-sale just in case the short-seller does not make profits and is unable to return shares to the lender. Initial margin and maintenance margin are the two types of margin requirements. The initial margin is a term that means the percentage of the value of shares that are deposited with the broker when initiating a trade. The maintenance margin is the percentage of the shares in the market that is held as a margin after opening a trade. Some stock markets such as Colombo Stock Market do not have the short selling facility.

Buying Stocks on Margin

Two methods that can be used to purchase stocks include:

- The purchaser can pay the price in full
- By the use of a margin account

When using a margin account, the buyer pays part of the purchase price, and the margin or the broker lends the remaining amount. The buyer then pays interest on the loan of the broker in addition to the agreed commission fee. The broker holds on the stock for security. Dividends earned from the stocks help offset interest payments.

Margin trading is the buying of stocks by borrowing a part of the investment using shares as security. It is purchasing stocks without paying the full amount using the money.

Advantages of Margin Trading

- It is the best for experienced stock investors who have a thorough knowledge of stock market trends.
- Earns more profit with less investment- stock investors make use of margin trading to increase their power of buying to own more stock thus making more significant gains.
- Increased purchasing power even when you have less money.
- It is suitable for day traders who require opening many trades with larger volume stocks.

Disadvantages of Margin Trading

- It is not recommended for novice investors.
- You are required to pay off the interest that accrues on margin.
- It is mandatory to keep a minimum account- also known as the maintenance margin.
- As an investor, you have less control over falling stock prices.
- It is not possible to trade all stocks.

Chapter 7:
Trends in Swing Trading

Swing trading is one of the best ways you can use to make a lot of money. It provides you with the prospect of generating money based on the quality of the trades you open. The more experienced you are at trading the higher your potential of making huge gains. Forex markets move in different patterns that can be categorized into two groups:

- Consolidating
- Trending

A market is said to be trending when the price puts in greater lows and highs in an uptrend and does the opposite for a downward movement. The thrust in the major direction is known as an impulse motion and a recovery in price against the direction of the impulse is called a price correction. The word “move” can be substituted by the word “swing”. The diagram below shows a price movement or swing in a trending market.

Swing trading is the practice of making profits from short-term movement of prices of securities. In swing trading, trades are left open for a few days to a few weeks. Sometimes they can be left open for a maximum of one or two months. Swing traders can be institutions such as hedge funds or individuals. They rarely invest 100 percent in the market at any time but they wait for low-risk trading opportunities in the market and ensure they make a lot of money from the opportunity. When the market is riding high, they open many buy positions. When the market is weak, they open sell positions or short more often than they buy. When the market is calm (prices not changing much) they do not open any trades.

In many instances, swing traders are in between trend traders and day traders. Day traders never hold their stocks for longer than a day. Day trading usually lasts a few hours or a few minutes. A trend trader is trained to look into the key stock trends over a long period and can hold onto stocks for months or weeks.

Long term trading leads to good profits most of the time. Swing traders hold onto shares or stocks for more extended periods than day traders but less time compared to trend traders. They usually

open trades based on the share's monthly or intra-weekly predictions whether the predictions are inaccurate or not.

Majority of swing traders work best in markets that are constant-markets that are not moving. Constant markets happen when the price of indexes, stocks or other financial instruments rises for some days and reduce in value for the next couple of days only to rise again and fall again continuously. It can take several months without any change in major indexes and stocks, but an experienced swing trader learns how to make considerable profits from short-term changes in prices.

The sure-fire way of making profits for a trader working on long-term trends or a swing trader is to understand the type of market being experienced at all times. Trend trading worked best during the Bull Run in the market that happened towards the end of the 1990s. Swing trading produced the best results between the year 2000 and 2001.

What are trend line and trend length and their roles

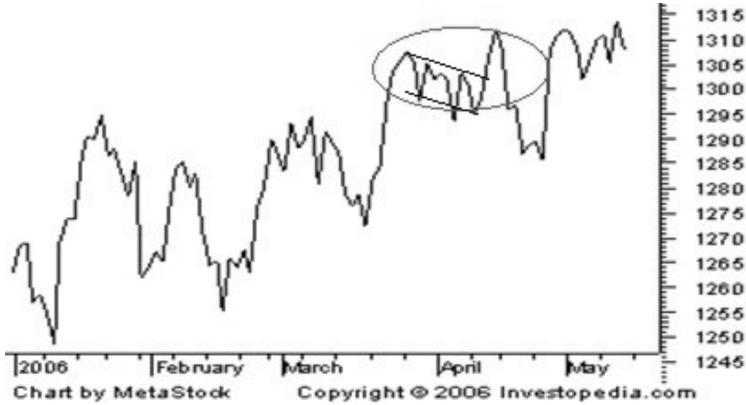
Now that you are familiar with the different types of charts, the next thing you want to understand is how to read them. Before doing so, though, let us look at trend lines and trend lengths-the principal tools used for the analysis of technical charts. Let's look at them individually:

- Trend lines: A trend line is a straight line that connects all the tops or bottoms in stock charts with each other. We touched upon trend lines in one of the previous sections. Here, we concern ourselves more with their utility.

Trend lines are essential because trends are sometimes not so-clearly visible in technical charts. How often we see zigzag patches! They make stock analysis tricky.

To reduce this distortion, an external aid has to be used. Take the example of the line chart we saw earlier. We have reproduced it below with a few additional touches. Look at the section that has been highlighted. At the outset, there is no clear reason to say whether the price trend is upwards or downwards. Tops and bottoms in this section are not clearly going higher or lower conclusively. How, then, will you go about your chart analysis

here? Using trend lines may prove helpful as they may be able to cut through the confusion here. We have done just this.



Since trend lines are straight lines, they smooth out the 'waviness' in the charts and accentuate the trends hidden in the stock chart.

For the above chart, we have used two trend lines – one each for tops and bottoms respectively. The use of trend lines in a combination like this is called a channel. It helps us understand whether the trend is upwards or downwards. Cast your mind back to our conversation about market trends. Recall that a stable uptrend, for example, is marked not only by increasing tops, but also increasing bottoms. By using a single trend line, you will only be able to comment about one of these. To spot a trend, you must use a combination of trend lines. In other words, draw a channel.

- Trend length: When analyzing technical charts, it is important to not only spot trends, but also predict the length of these trends. We discussed this in the section on market trends. We acknowledged that primary trends are the longest lasting and bring about the most radical movement in stock prices. A decisive move in a stock price, for a sustained period will only come if the trend is strong and enduring. Minor trends and, in some cases even secondary trends, are unable to cause such a meaningful impact. They may only pass off as a flash in the pan. The longevity of a stock trend can be predicted by using patterns in the charts. One can start off with an analysis of trend lines themselves. If trend lines suggest that each

time the stock price rises to a higher level before falling, it is suggestive of an uptrend. However, the trend is confirmed only if simultaneously, the falls are also smaller. Some of the other measures to assess the longevity and conviction in technical charts are head and shoulders, inverse head and shoulders and, double tops and double bottoms. We will look at them in the next section.

What are the different types of charts?

As we discussed in the previous section, there are four types of stock charts that are principally used in technical analysis. These are:

- Bar charts: A bar chart is similar to a line chart. However, it is much more detailed and informative.
- Line charts: A line chart is the figure that automatically comes to mind when you think of a chart.

Many people are aware of the fact that historical data shows a market that is right for swing traders. Majority of experienced swing traders have liquid shares that tend to trade under and over a specific value. This can be explained clearly using the Exponential Moving Average graph or chart.

A renowned writer called Dr. Alexander Elder explains his understanding of share's fall and rise behavior around the baseline and shows the swing trader's aims of buying and selling. After the swing traders figure out how to use the Exponential Moving Average to determine the baseline on the share's graph, they can follow the baseline when stocks start falling and rising.

Swing trading differs from buy-and-hold investing or day trading. Day traders and other types of investors have a different trading approach. They also trade at different frequencies and pay attention to different sources of information. It is mandatory for you to understand these differences so that you focus on aspects that are essential to short-term investors.

In brief, swing trading is a perfect method of trading shares and stocks for numerous people because it provides an ideal medium between day trading and trend trading. This book will help you learn how to identify promising sectors and markets to trade; use technical analysis and fundamental analysis in swing trading and

manage security risk and portfolio.

Hot Sector Manias

Unlike similar investment bubbles such as the Dutch Tulip Bulb mania in the beginning of the 17th century, the Japanese shares and property boom of the 1980s and the United States dotcom technology bubble, Bitcoin is considered the first truly global mania.

That factor alone propelled the ensuing boom much higher than those earlier ones, all of which happened when a particular set of circumstances came into play.

Mania building blocks

The fundamental building blocks of an investment mania are generally considered to be:

- A strong period of economic growth, which conditions investors to accept strongly rising asset prices as a "normal" phenomenon.
- Easily accessible credit, which can be used to buy commodities (such as tulip bulbs), physical assets (like property) or financial assets (such as stocks or bonds).
- A surprising new "asset" or technology that is seen to be capable of incredible growth in value.

Bitcoin and its many digital coin clones and "initial coin offerings" arrived at a perfect time to be the subject of the latest mania or investment craze.

Central banks print money

After the GFC most big central banks (notably the US, EU and Japan) had turned their money printing presses on to overdrive, slashing interest rates to incredible new lows and flooding markets with excess liquidity.

In general, the efforts of the central banks were eventually successful, breathing new life into crippled markets and slowly but surely rebuilding investor and banking confidence after the crushing frozen markets and collapsing asset values of the GFC. Global share and bond markets gradually defrosted and asset prices

across the board began to rise sustainably again.

Excess liquidity finds a home

However, all of that lovely cash had to find a home and some of it was diverted into more speculative areas, such as emerging share markets and Bitcoin. The sexy attraction of Bitcoin is not dissimilar to earlier investment bubbles forming around the latest new technology such as railways or electricity.

Bitcoin becomes the future

Bitcoin was to be a new global currency, better than any existing currency because their scarcity value was guaranteed because they could only be produced or **mined** through the intensive use of computer time and electricity.

Unlike the irresponsible central banks that simply printed money-so the spiel went- Bitcoins were the future because they had a more secure store of value and could be transacted securely and globally with strong record-keeping using revolutionary block chain technology.

Soon stories about people becoming millionaires through investing in Bitcoin were everywhere and the mania went into hyper-drive, as members of the general public flocked to Bitcoin to make their own fortune.

Many of these new investors were using credit to buy their Bitcoins and in some cases they were mortgaging houses and using credit cards to get a piece of the action.

Bitcoin reality is difficult

Unfortunately, despite all of the hype, Bitcoin remained a difficult beast to invest money in. Transaction costs through competing Bitcoin exchanges are substantial and the block chain technology in its current form proved to be quite constrained in recording transactions.

It is also quite difficult to work out the true or intrinsic value of a Bitcoin because it depends on the ability to find a “greater fool” to sell it to and keep the price rising rather than the cost of producing a new Bitcoin.

The fundamental value of any asset includes factors such as the ability to generate cash flow (such as interest or rental income); how scarce or rare it is (such as gold, platinum or diamonds); and its potential usefulness (such as coal, iron ore or lithium).

Property is a sort of combination asset because it can have value due to the scarcity of land in a particular area and also has the ability to generate a rental income. Bitcoin doesn't really have much in the way of intrinsic value or usefulness in earning an income.

That did not stop it becoming part of a "euphoric" price boom, in which true value is lost and investors simply look at the rising price as proof that their investment is working.

Chapter 8:
How to Analyze Stock Charts
There are four types of trading charts that are commonly used by investors to understand movement in the stock market and other trading markets:

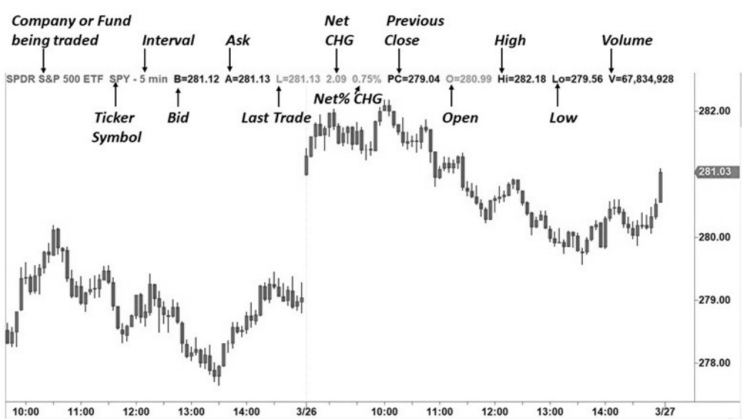
- Daily Charts
- Weekly Charts
- Monthly Charts
- Intraday Charts

The different types of trading charts illustrate a few ways price movement is expressed over a period of time.

Interpreting Trading Chart Data

Before you can use a stock market chart to plan a trade you have to understand what the data on the chart means. The top of the chart often displays helpful identification and price data points to assist the investor or trader in monitoring daily price and trading activity. These values are updated moment by moment throughout the day as new buy and sell orders enter the markets and old orders are filled or canceled.

Here's an explanation of stock market chart data points as labeled on the chart.

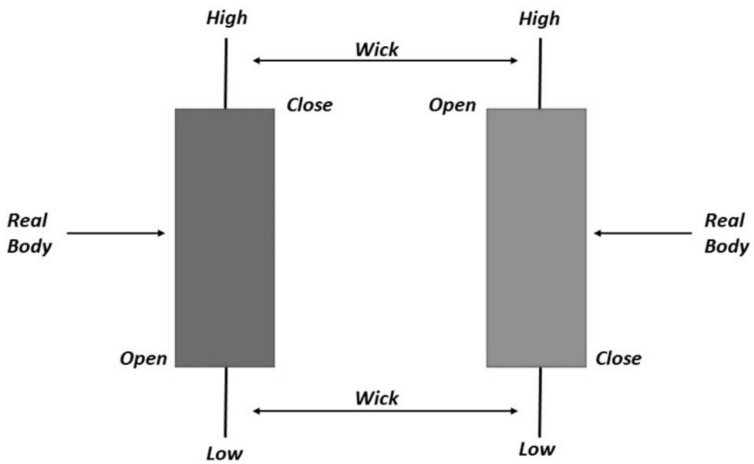


- **Company** or Fund being traded-Indicates the particular company or fund whose price data is being shown.

- **Ticker Symbol-** Tells you the stock market ticker symbol of the company or fund whose price data is being shown.
- **Interval-** Charts can be viewed in a variety of timer intervals (e.g. 2 minute, 5 minute, daily, etc.). This indicates which interval the chart represents.
- **Bid** -Represented by a B at the top of the chart, this indicates the highest price at which someone is willing to buy this stock or fund.
- **Ask** -Represented by an A at the top of the chart, this indicates the lowest price at which someone is willing to sell this stock or fund.
- **Last-** Indicates the price of the Last trade placed.
- **Net CHG** -Indicates the difference in price between the Last trade and the price at close the previous trading day.
- **Net percent CHG** -Because a $1 move in a $50 stock is more significant that a $1 move in a $200 stock, Net percent Change more accurately represents the amount of price change for the stock or fund.
- **Previous Close-** Represented as PC on the top of the chart, this indicates the price of the stock at close the previous trading day.
- **Open** -Represented as O on the top of the chart, this indicates the price when the market opened that particular day.
- **High** -Represented as Hi on the top of the chart, this indicates the highest price the stock has traded at for the day.
- **Low** -Represented as Lo on the top of the chart, this indicates the lowest price the stock has traded at for the day.
- **Volume** -Represented as V on the top of the chart, this indicates the number of shares that are being traded throughout the session, offering a sense of how actively the stock is being traded relative to the most recent trading days.

Bar charts with **Candlesticks** (so-called because they look like a candle of various heights with a wick extending from the top and/ or bottom) are commonly used to show trading activity through various timeframes within the chart. The range is defined as the

difference between the High (top of the wick, or candle if there is no wick) and Low (bottom of the wick, or candle if there is no wick). The top or bottom of the colored candle represent the price at open or close for the period being plotted.



With an understanding of the data provided on a stock market chart, you can then begin to learn what style of trading a monthly stock chart is used for vs. a weekly stock chart, etcetera.

Picking stocks is challenging but gaining an understanding of stock charts is the most important step to success. This chapter will teach you how to read a stock chart in detail. The chapter features an effective approach for picking individual stocks. Suppose you are a new investor, we suggest starting out with investments in mutual funds or index funds. This is crucial because it will help diversify your portfolio and reduce risk while you gain more knowledge about stocks in the stock market.

If you do decide to invest in individual stocks, we do not suggest you allocate more than 10 percent of your portfolio to individual stock picking. This chapter focuses on how to evaluate individual companies. If you are an experienced investor and want to learn a key tool for picking individual stocks, read on.

If you are a new investor or even if you are not you must be aware that reading a stock chart is not a walk in the park. But it is a core skill you will need if you want to find viable investments for your

portfolio. In this chapter, I will break down the essentials stock chart and explain the key things you need to focus on. Pair this with some knowledge of value investing and you will be well on your way to picking stocks.

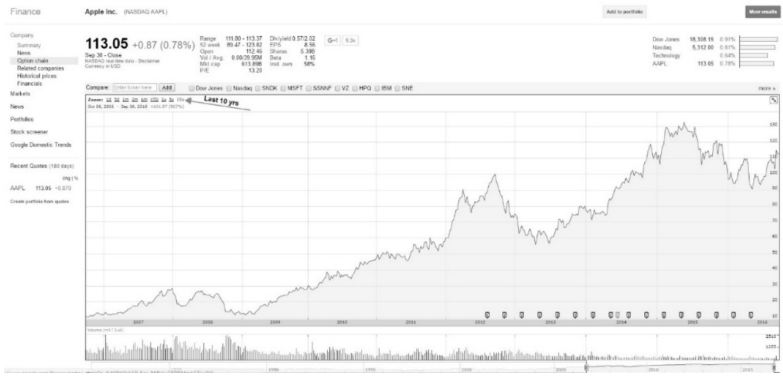
What is a stock chart?

My favorite website to look at basic stock information is Google Finance. I used to use Yahoo! Finance, but I think Google has a slicker interface. Now let us take a look at a typical stock chart. We will use Apple for this chapter.

If you do not already know, the series of letters after the name of the company is the ticker symbol. It identifies the company on the stock exchange. In this case, we will search AAPL, which is Apple's ticker symbol. This is what we get:



Next, click the button to expand the chart to full screen and it will look like this:

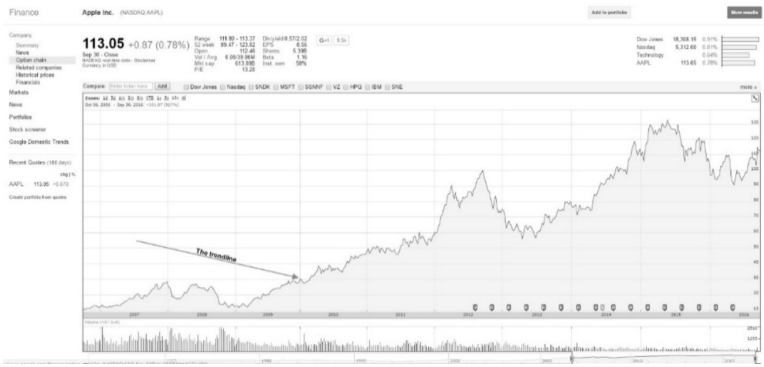


I've also taken the liberty of filtering only to the last 10 years,

which you can easily do by clicking the corresponding button (which I have highlighted for you). So here we are looking at the last 10 years of Apple's stock. I bet you wish you would have gotten in in late 2008! Now let us dive into the different pieces and parts of the stock chart so you can begin to read one like a pro.

How to read a stock chart

a. Identify the trend line



This is that blue line you see every time you hear about a stock-it is either going up or down right? While the trend line seems like common sense, there are a few things I want to call out so you can understand it in a little more detail.

First, know that stocks will take huge dives and also make huge climbs. If you have followed the advice I gave in the value investing piece, you will know that you have to keep your emotions in check to be a successful investor.

Do not react to large drops or huge gains in a positive or negative way. You should be using this piece of the stock chart merely to see what's going on. In fact, the trend line should lead you to dig further. For instance Apple as a company really took off from 2009 to 2012. But what happened from 2012 to 2013? The stock began to sink-at one time; shares were down more than 4o percent!

This is where your trend line comes in handy. News comes and goes, but when news coincides with a dramatic shift in the trend line, it is something to pay attention to. If you saw something like this happen, I would urge you to find out what's going on with the company. Most strong companies can rebound from hits like this,

but not all can. For those that do not know, right around this time Apple experienced a few major shifts:

First, it is longtime CEO, Steve Jobs, resigned (2011). Also, around 2012, Apple noted that their profit margins were significantly decreasing, despite a growing smartphone market. Finally, they were trying to expand the smartphone into developing countries, where they were just too expensive to compete.

These factors, combined with plenty of other variables, contributed to the stock price falling. But new Chief Executive Officer Tim Cook made some strategic moves with the company to turn it around, and the rest of the trend line shows that. The lesson here is to use your trend line as a first-glance, high-level indicator of something to look into.

b. Look for lines of support and resistance

The next things you will want to look at are the lines of resistance and support. These are levels at which the stock stays within, over a given period of time. A level of support is a price that a stock is unlikely to drop below, while a level of resistance is one that it is unlikely to go above.

That is until some major change occurs, such as a reduced profit margin. Think of these lines like bumpers at a bowling alley. When you are bowling, the ball bounces back and forth between these inflated barriers. A stock's price does the same thing within these lines of support and resistance. The goal here is to know when to buy and when to sell. Let us take a look at Apple's stock chart again to see an example:



These are subjective and interpreted differently by everyone, but the process is important. First know that everyone will draw lines of resistance and support differently, depending on their investment horizon (how long they plan to hold the stock).

So if you plan on holding it for a long time, you may not draw as many lines of support and resistance, because you do not care as much about the ups and downs. But if you are a short-term investor, you may draw more to analyze trends during a shorter period.

Let me break down the image above with each of the trend lines:

- Line A is the very first line of support shown. Based on trends prior to this, I would feel comfortable that the stock price won't go below this point. I would probably consider buying at this price or higher.
- Line B is my first line of resistance. I see that the stock has peaked at that point for now and I wouldn't expect it to go higher. I would probably consider selling at this price or slightly lower.
- As you can see with Line C, the stock has bottomed out again, thus creating a new line of support.
- Line D shows the stock price has increased significantly and I'm comfortable establishing this as a new line of resistance.
- You can see the trend continue with Lines E, F, G, and H, bringing new lines of support and resistance as time goes on.

If it seems complex, do not fret. It is. And a lot of it is guesswork. If I were to buy stock in Apple today, I would make note of my most recent line of resistance (Line G) pricing out at just over $130 a share and my most recent line of support (Line H), which was pricing at around $90 a share.

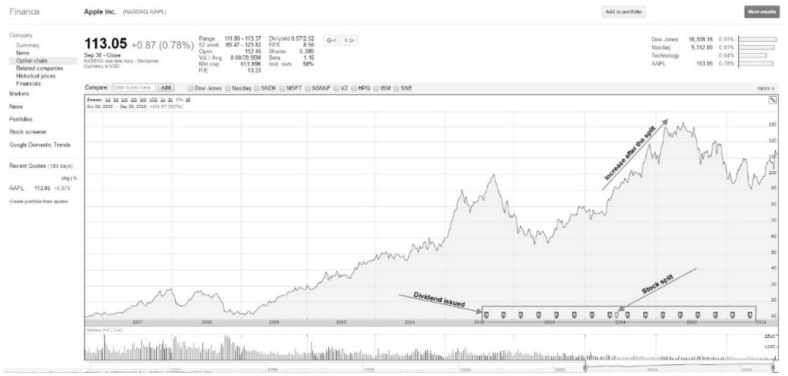
Knowing this, I can safely assume that the stock price won't drop below $90 and it shouldn't go above $130, barring any major news or company changes. At $113 per share currently, I feel that this is a good price point and would probably make a purchase. I might even wait to see if it drops below $110 to feel even better.

Knowing the lines of resistance can help you decide when to buy or

sell a stock. Remember, though, that it is subjective and it won't give you a clear-cut road map on exactly what to do. You will have to use some of your own analysis and judgment.

c. Know when dividends and stock splits occur

At the bottom of the chart, you will see if and when the company issued a dividend, as well as if there was ever a stock split:



A dividend is when the company (the board of directors) decides to give a portion of its earnings back to its shareholders. If you own the stock, you get a small chunk of the profit. Some companies issue dividends, some do not. Just because a company does or doesn't issue a dividend doesn't mean it is not worth investing in. There are plenty of other factors to consider.

Some companies just prefer to focus on growth, so they'll reinvest their earnings as opposed to giving it back to the shareholders. Other companies such as Apple can pay dividends without sacrificing growth. As you can see by the image, Apple started issuing quarterly dividends to its shareholders midway through 2012. You can also see that there was a stock split in 2014. A stock split is a strategic move done by the company's board of directors to issue more shares of stock to the public.

In this case, Apple did a seven to one stock split (noted as 7:1), which means that for every share of AAPL you owned prior to the split, you would now have seven. So if I owned 100 shares of APPL prior to the split, I would now have 700. The value of the company doesn't change, but the share price might. Companies will often do this if the price is not in line with competitors or to attract smaller

investors (if the share price decreases).

You can see the uptick in the trend line after the split occurred, too. Many times when a stock split happens, more people invest since the share price is often lower which increases demand and, in many cases, the overall share price.

d. Understand historic trading volumes

At the very bottom of the chart you can see many small, vertical lines. This is a trend of the volumes at which the stock is traded. Volumes are good to know, but shouldn't be your only determining factor when buying a stock. Usually trading volumes increase when there is major news whether good or bad about the company. When volumes are increasing, it can also shift the price of the stock quickly. Let us look at an example:



In Line A, you can see there was a high volume of trading activity that corresponded with a drop in the stock price. There may have been news that day that caused people to panic aside from the entire economy crashing that year.

In Line B, you can see a slight uptick in trading volume that corresponds with an upward trend in the stock price. Do not always assume there will be a correlation between stock price and trading volume, but it is good to know what the volumes have been in the past and what they are currently before making a decision. With high volumes comes greater ease when buying or selling. If a lot of people are trading the stock that day, you should be able to buy or sell it quickly.

Points to Note

That is the basics of reading a stock chart. Remember that past performance doesn't correlate to future indications on price. Meaning that just because Apple hit $130 per share recently doesn't mean it will again. There's also nothing to say it won't double in price. You just cannot know.

Most charts are useless, but these five can make you a better stock picker

These are some of the terms associated with technical analysis. The idea behind this investment style is that pricing patterns repeat themselves, and decisions can be made by looking at a stock's price movement and trading volume.

I have never believed in technical analysis. The evidence against technical analysis is extremely strong. He highlighted a 2009 study by Massey University in New Zealand that tested more than 5,000 technical analysis strategies. The study showed that no strategy generated returns that aren't predicted by chance.

That data helped to confirm my suspicion that almost all technical analysis chart patterns are useless. However, that does not mean that all charts are useless.

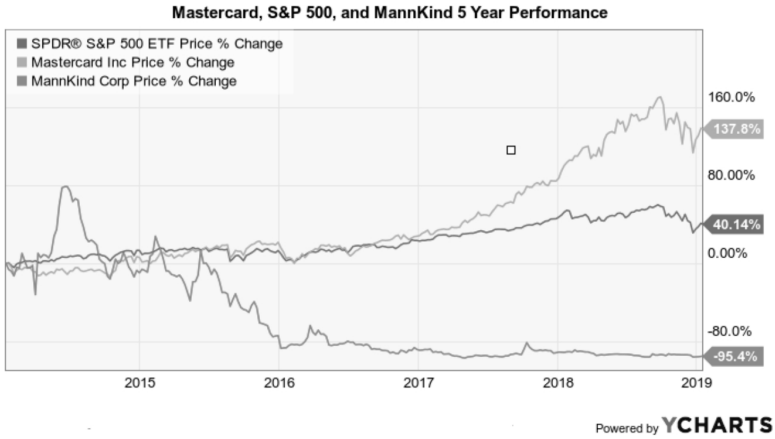
Here are five charts that I use to find great businesses:

- **Performance versus the S&P 500**

I'm a firm believer that winners tend to keep on winning. One of the first things I look at when I'm researching a stock is how it has performed versus the market over time.

My primary yardstick is to compare a stock with the S&P 500 over the last five years, but I also check how the company has performed since its IPO. If it has walloped the market, then I get interested. If it has lost badly, then I usually write it off.

If you want to see what a wonderful long-term chart looks like, consider MasterCard (NYSE:MA). The payment processing giant has thrashed the index over the last five years. Conversely, MannKind, which is a struggling commercial-stage biopharma, has a five-year chart that is about as ugly as it gets.



SPY data by Ycharts



The numbers diverge even more when we start from MasterCard's IPO in 2006.

MNKD data by Ycharts

This chart shows that MasterCard has done a phenomenal job of rewarding long-term shareholders. By contrast, MannKind's total loss of 99 percent couldn't be much worse.

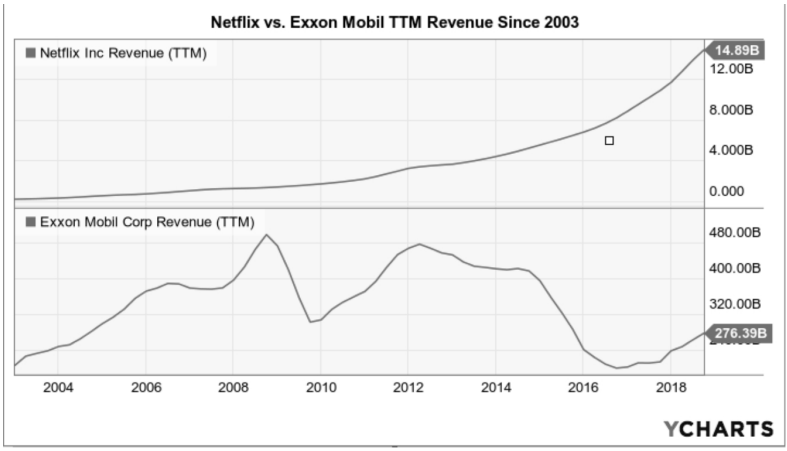
- **Long-Term Revenue Growth**

I like to invest in companies that post consistent revenue growth. When a company can do so for years on end, it tells me that the

business is successfully riding a long-term trend and that it is not dependent on outside forces for success.

Let's compare two well-known stocks to hammer this point home: streaming kingpin Netflix (NASDAQ:NFLX) and energy giant ExxonMobil. Both companies have thumped the market since they went public and have been spectacular long-term investments.

However, a look at their annual revenue over the last 15 years tells an interesting story:



NFLX Revenue (TTM) data by Ycharts

Netflix's revenue consistently moves higher every year. This 15-year time window includes the 2008 recession and the company's Qwikster debacle. I find the company's consistent revenue growth to be highly appealing.

By contrast, ExxonMobil's revenue fluctuates wildly from year to year. When energy prices are high, the company's revenue soars.

This chart makes one thing clear to me: ExxonMobil is heavily dependent on an outside force-the price of oil-for its success. By contrast, Netflix appears to be in complete control of its top line.

This is a big reason why Netflix is a major part of my portfolio and ExxonMobil is not.

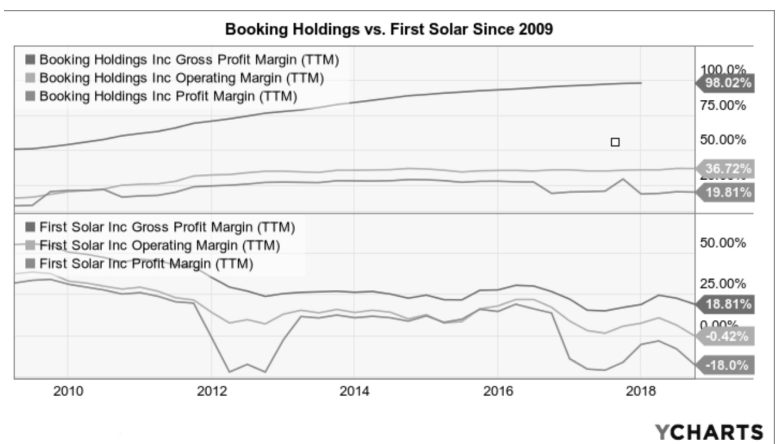
- Margin Trends

Margins matter a lot. The best growth companies take advantage of their increasing scale by spreading their fixed costs over a larger base of customers. This helps drive operating leverage and can lead to outsized growth on the bottom line.

This is why I always look at a company's gross, operating, and profit margins over time. If they are holding steady or increasing, then it is a great sign for investors. If they trend downward, then it suggests that all of the value creation is being captured by the company's customers or suppliers and not by investors.

A 10-year chart that compares travel giant Booking Holdings (NASDAQ:BKNG) to solar panel maker First Solar showcases this point beautifully. Both companies are big players in growing markets. Both have far more scale today than they did a decade ago.

However, a chart of these companies' margins over time tells an interesting story:



BKNG Gross Profit Margin (TTM) data by YCharts

Booking Holdings has done a phenomenal job at using its scale to drive operating leverage. When combined with its huge revenue growth, it is understandable why its stock is up more than 2,300 percent over the past decade.

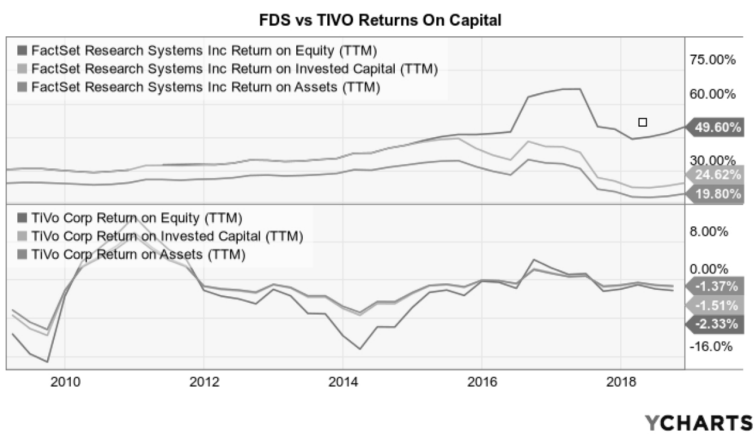
The opposite is true with First Solar. Its margins have all consistently trended downward. This indicates that the company is

being forced to grant pricing concessions in order to win new business. While pursuing that strategy has translated into increased revenue growth, it hasn't benefited investors much. First Solar's stock has actually declined by more than 60 percent over the last decade.

- Returns on Capital

Great businesses create value. Bad businesses destroy value. One way that I check to see whether or not a company is creating value is by looking at its return on equity, return on assets, and return on invested capital over time. If these figures are high, then it is a great indicator that it is creating value as it grows. If the numbers are in the low single digits or negative for extended periods of time, then it is a sign that the business is destroying value and is not worth investing in.

A comparison between the data provider FactSet Research Systems (NYSE:FDS) and the consumer electronics company TiVo illustrates this point well:



FDS Return on Equity (TTM) data by YCharts

FactSet does a great job at generating strong returns on capital each and every year. TiVo's return metrics have gone up and down over time, and they are all currently negative.

This tells me that when FactSet reinvests into its core business, it creates a lot of shareholder value. TiVo's numbers suggest that it is

just a value-destroying machine.

- Dilution

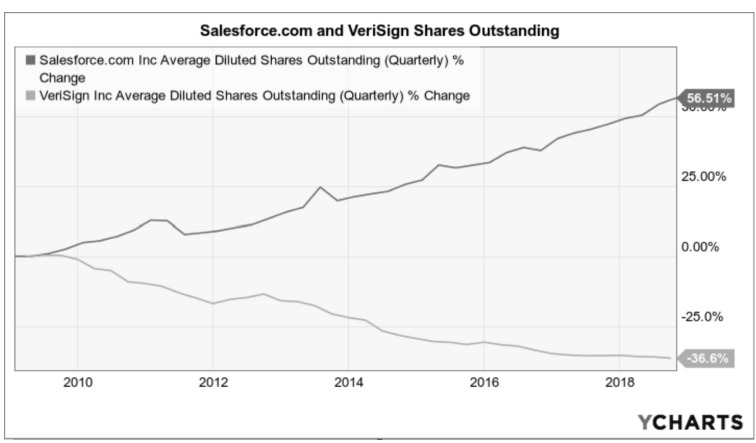
Stock-based compensation is a tool that many growth companies use to reward and retain employees. This is especially true in the fast-moving tech sector, where attracting top-tier engineering and executive talent is crucial.

A side effect of issuing a lot of stock-based compensation is that investors are constantly being diluted. While some dilution is perfectly acceptable, I like to know just how bad it is before I take a position in a stock.

Conversely, some highly profitable companies buy back their stock in huge amounts over time. This can lead to a shrinking share count, which can greatly benefit investors.

Take a look at two Uber-successful tech companies: software-as-a-service pioneer Sales Force and registry services provider VeriSign (NASDAQ:VRSN). Sales force is well known for being very generous with issuing stock-based compensation. VeriSign has been plowing all of its profits into stock buybacks for years.

This has created a huge difference in the dilution rate for these two businesses over time:



CRM Average Diluted Shares Outstanding (Quarterly) data by YCharts

Sales force shareholders have been diluted by more than 50percent over the last decade. Long-term VeriSign shareholders now own a higher percentage of the business than they did a decade ago.

It is worth pointing out that high levels of dilution do not automatically disqualify a company from being a good investment. Sales force's growth has been so fantastic over this time period that investors have still made out like bandits even with the huge dilution. However, I still believe that looking at this chart can be highly informative for investors.

Make charting work for you

I do not think that these five charts alone provide enough data for investors to make decisions. That is why they are just a part of the checklist that I use to judge whether or not a business is worth considering.

But I am very confident that these five charts can be very useful in helping investors to pick better stocks

Chapter 9:
Managing Risk

What Are the Risks Associated with Swing Trading?

There are certainly a few risks to consider. Swing traders focus on short-term trends, making them potentially vulnerable to unexpected market shocks that could send prices sharply in one direction. While less intense than day trading, swing trading is still quite pressured and time consuming. Holding stocks overnight makes swing traders more vulnerable than day traders when it comes to market-impacting events that may become breaking news overnight. Short-term trading generally involves smaller profits than longer-term strategies, and commissions on regular trades eat into those profits. To swing trade successfully, you have to be able to read and analyze various technical indicators and use them together to make sense of market trends.

This takes time to learn and means human error is always possible. One of the strongest predictors of how successful you will be as a swing trader is your ability to manage risk. To limit risk, you will need to diversify your portfolio and have a well-thought-out strategy regarding stop loss limits. You will need to set stop loss limits for each individual stock and work out how these will impact your portfolio as a whole. Successful swing traders tend to be those who are well versed in technical analysis and have learned to manage risk strategically.

Risk management is essential to trading. All traders make losing trades sometimes. But good traders respect and manage their risks. You must be able to manage your risk and cut losses so you can continue to trade. Managing risk also means protecting your capital. It is important to not let a bad trade drain your account. There are several ways to protect your trades from unexpected changes in the market.

Define leveraged trading

Leveraged trading is making trades in the market using leverage. Leverage is using the borrowed capital to increase your trading exposure. Leveraged trading gives traders a chance to earn more than possible with just the original capital invested, which is

usually a small percentage of your full trade value. Leverage trading is great when prices move in your favor. You could end up making heavy losses as well, however, if markets move in the opposite direction.

If you trade using leverage, you can take a small capital and use it to control a bigger sum of an asset. Your profit potential increases if the market changes in your favor. But your loss potential also increases if market prices move in the opposite direction. Be careful when using leverage so as not to increase your risk.

Monitoring your spread

You must know how spreads work to track the potential for risk. Whatever spread betting platform you use, it will offer two prices for your trading instrument. These two prices are the buying price and selling price. Traders buy when they expect market prices to rise and sell when they expect prices to fall. The spread is the difference between the buy price and sell price of an instrument. Brokers wrap their cost in the spread that is offered to you. A wider spread implies a higher cost of trading. Trading costs will be lower when the spread is lower.

How stop losses work

Protect your trade from rapid changes in the market by using stop losses. Stop-loss orders are a handy tool to protect your trades when prices move against you. You can calculate in advance the maximum loss you are willing to take per trade in case prices move in the opposite direction. This will prevent you from losing more money. Stop losses help prevent larger losses from occurring in a quickly changing market. Stop losses are a great tool for risk management. This tool is offered by most trading platforms.

Difference between stop-loss orders and guaranteed stop-loss orders

A stop-loss order does not guarantee that your trade will close out at your pre-set price. So if the price of the market does slip lower than your pre-defined price, you could end up losing more than you expected. Slippage or gapping usually happens when market prices rise or fall suddenly by large amounts. Such sudden price changes are usually caused by unexpected news or market-moving events.

Your trade could close out at a worse price. A guaranteed stop-loss order automatically stops your trade at the precise point you have set. This will happen despite any slippage or gapping.

What is a take-profit order?

Take-profit orders work in much the same way as a stop-loss order. The key difference is that a take-profit order automatically stops your trade at a pre-set level to make a profit.

Using a Reward to Risk ratio

A reward to risk ratio is a great tool for helping to minimize risk. This ratio is a measure of reward versus risk. Using the risk to reward ratio will help you predict your profit for a trade against how much you are content to lose. This amount depends on your personal trading goals and finances.

Calculate your ratio by taking the total potential profit and then dividing it by your total potential loss. If your reward to risk ratio is 1:1, then you must have higher than a 50 percent rate of profit to make a profit long-term. So you must have a winning trade for every trade you lose.

Use your reward to risk ratio with stop orders to help minimize losses and increase your potential for earning on your trades.

Important points to consider

- Invest a reasonable amount of money in comparison to the number of fees you will pay the stockbroker.
- Exercise self-discipline by committing to a long-term investment approach, and always monitor the performance of your investment.
- Be patient by ensuring that you are not emotionally attached to your investment. Every trading day is different. You may make profits on some days and also lose on other days. Make sure your investment strategy is profitable in the long-run.
- See to it that your investment portfolio is diversified.
- Do not borrow funds to invest, mainly if you are unsure whether you will make enough profits to repay the loan.

Risk management tips

Apart from stop-loss orders and diversification, there are a number

of tips that one may follow to reduce risk including:

Make the trend a companion

One may have decided to hold a position for an extended time. However, every trader should recognize that no matter the position they take, there is no fighting against the market trends and movements. Accommodate the changes and make sure that the trading strategies reflect the new aspects; this will help one to reduce risk.

Keep learning

There is always new information coming up in the market every day. As the world changes, so does the economy and so does the market. A trader should know how the market is function currently, how it evolved and where it might be heading.

Use tools and software programs

Use of tools and programs can help one select a good choice and avoid risk. However, it is important to note that these systems are man-made therefore aren't entirely perfect. It is best to use them as a tool of advice rather than a complete basis of trading decisions.

Use limited leverage

Leveraging is very attractive because it gives a trader the opportunity to make bigger profits. However, leverage also increases the chances of losing capital; therefore, one should avoid taking massive leverage. One wrong move with leverage and the entire account is wiped out.

Forex risk management involves a lot of aspects that are actually very easy to understand. Most of them have been covered in this book. The hard part is to summon enough self-discipline to follow the rules when the market is dictating otherwise. The bottom line is, when a trader limits risk, he or she is able to stay in the game for longer and continue investing even under adverse conditions.

Portfolio Management

Portfolio management refers to the choice of securities and their constant shifting from the portfolio to maximize the yields to match the specific objectives of the investor. However, it requires

experience in choosing the ideal combination of securities in altering marketplace conditions to get the most out of this stock exchange. In India, in addition to in several western nations, portfolio management agency has assumed the function of technical support, and several of expert merchant bankers compete aggressively to supply the very best to wealthy customers, who have very little time to handle their investments.

Chapter 10:
The Basics of Fundamental Analysis

In the foreign exchange, fundamental analysis refers to the act of trading in the market based on the analysis of the global aspects that determine the demand and supply of currencies. A sizeable number of traders use both the fundamental and the technical analysis together to determent the when and where to trade. However, the traders tend to favor one over the other based on their individual investment plans and goals. To be precise, fundamental analysis studies aspects such as political forces, economic forces, and socials forces that may affect the asset. Many traders find ease in predicting the movement of prices while using supply and demand as an indicator. In simpler terms, the trader using fundamental analysis has to identify the economies that are blossoming and those that are stuck. As such, the trader has to know the whys and how an aspect will impact the trade, for instance, unemployment rates. The rates of unemployment affect the economy and the monetary policies implemented by the government and central banks, therefore, affecting the levels of demand and supply of the nation's currency worldwide.

Traders that use fundamental analysis pay attention to the overall state of a nation's economy and identify factors such as interest rates GDP, international trade, manufacturing, and international trade among others. The impact of these factors on the currency affects the price of the currency on the forex trade. The bottom line of fundamental analysis in the forex trade and also other markets is that an asset can have a price that differs from its actual value. Consequently, markets may misprice, underprice or overprice an asset in the short term. Fundamental analysts claim that despite misquote of the currency, an asset will still go back to its actual price indicating its true value. Then we can say that the bottom line of traders who use fundamental analysis to gauge assets are looking for trading opportunities through analyzing the value of the asset, the current price and the possibility of change.

The main difference between fundamental analysis and technical analysis is that fundamental analysis pays attention to all other factors of affecting the trade apart from the price while the technical analysis focuses on the price only. As such, the technical

analysis is very handy for short term traders such as those in day trading while the fundamental analysis is beneficial for the long term traders such as those in the swing trading. The analysis of fundamental foreign exchange factors answers the long term questions.

Fundamental analysis tools

Fundamental analysis is done via different tool and the most used ones include the financial news media, the economic calendar, and historical fundamental data. The financial news media gives news podcasts that update the traders of any major geopolitical and economic developments. That might affect the market directly or indirectly. The economic calendar helps the trader to assess the date and time schedules of the release of data, either major or minor, that might affect the currencies.

Historical fundamental data is useful to the trader because it is enabling them to determine the trends in indicators. The traders can also analyze how a currency reacts to certain economic information release. This can be done by analyzing the behavior of the currency in the wake of previous similar releases and decisions. There also other sources that one may use to base his or her opinion and they include the central banks, weather, and seasonality.

Central banks are probably one of the most charged sources of fundamental trading. This is because, they have a long list of actions they can take in finance, for instance, changing the interest rates (raising them or lowering them), maintaining the rates, making suggestions about the possible changes, the introduction of new policies, revaluation of the currency among others. The fundamental analysis of central banks usually involves thorough poring through speeches and statements made by central banks and attempt to predict their next moves.

One might wonder how the weather affects the forex exchange yet they seem unrelated in all ways. There are types of weather that can affect currencies in different countries. For example, in the winter season, a snow stomp in a country may drive the costs of natural gas up because it will be on high demand for heating homes. Also, there are certain weather situations that affect the value of good for example droughts, hurricanes, floods, and

tornados. Some of these weather events are unpredictable to a large extent but it would not hurt for one to check the weather channels and identify the weather unfolding.

Seasonality might be related to weather but in this case, it is about some factors unrelated to weather. Seasonality means a period of time or rather time series. In trade, there are seasons that are good for selling while others are good for holding assets. For instance, in December, many investors sell off their securities if they have been declining throughout the year so that they can claim capital losses on tax. Sometimes, it is beneficial for a trader to exit a position before the selloff at the end of the year begins. Other seasons include the beginning of the year (January effect), and the end of the month (Month-end rebalancing.)

Fundamental analysis indicators

There are many indicators used in fundamental analysis and they vary according to the nation. Currency traders use the indicators to assess the current and future state of the economy in the country. Some of the indicators include; Gross Domestic Product, trade balance, Currency account, employment data, inflation, and retail sales. Some of these indicators may help the trader to idealize what the future release will look like. Again, some of the indicators lead others in signaling the upturn or downturn of the economy. They include durable goods orders numbers, Producer Price Index, and purchasing manager surveys.

Some of the geopolitical events that can affect the forex market include elections, war, change of powers and natural disasters.

Fundamental analysis: Trading on the news

Some traders using the fundamental analysis follow data releases and economic news to initiate (enter) or liquidate (exit) the short term trades. They base their decision on the results of the release. It may sound easy to trade on fundamental news but a trader should be aware that in most cases, the market does not react as expected. A number of times, the market will go to the opposite direction of what the traders anticipated.

When trading on the news, the traders use volatility strategies that involve the sale and purchase of options. The options are helpful in

retaining a neutral position hence appreciating regardless of the direction that the market moves. Traders also take advantage of the news related volatility when they trade with fundamentals by establishing a short and a long position in one pair and then close each side when the news is released.

Many professional traders avoid holding a large position just before a significant economic release. This is because the volatility associated with news release could initiate stop positions on any side. Trade fundamental analysis allows a trader to have a deeper understanding of the ways in which the market reacts to events. Combining the technical analysis and the fundament information gives the trader an edge over the traders that are using one method.

Approaches to fundamental analysis

Keep in mind that Foreign exchange prices are influenced by the microeconomic and the macroeconomic data, geopolitical events, and the linkages. As seen earlier, the factors include GDP, Employment statistics, trade balances, and interest rates among others.

Top-Down Analysis

The top-down analysis starts with an analysis of the broad brush factors of macroeconomics and aggregates of data that works downwards. The traders narrow and refine the searches to only the pairs that present a potential for profit.

Bottom-Up analysis

Unlike the top-down analysis, the bottom-up analysis starts by analyzing the pair of currencies and then working upwards to the aggregate macroeconomics information.

Interest rates and balance of trade

These are some of the key drivers of currency and their prices. For example, if a country has surplus trade balance, then it means that the demand for services and goods is very high. Consequently, there will be a greater demand for the nations' currency thus increasing the relative value. Also, higher relative interest rates result in cash inflows, therefore, driving the value of the currency up.

Forces driving the demand and supply

These forces have a significant impact on how the commodities are valued. For instance, an occurrence of international war may lead to an increased demand for the metals used to manufacture ammunition and armaments, therefore, driving the prices up.

Chapter 11:
The Basics of Technical Analysis

Swing Trading and Technical Analysis

The time frame is the key in swing trading. A position may rise and fall in value in a 24-hour period or over a period of several weeks. To pinpoint the exact time to buy into a swing and sell out before it swings back (at a lower price), traders routinely use technical analysis to leverage the best swing trade opportunities. Technical analysis helps to calculate the "price action" of a particular security or fund and harness that action to maximize portfolio gains. For example, ABC stock is priced at a certain market level and a swing trader wishes to estimate, as closely as possible, where the price is going.

Technical analysis is invaluable in this estimate, as it leverages multiple stock market charts and indicators to identify the stock's price support among investors, while identifying any resistance to upward price performance through the analysis of stock price ranges and trading trends.

When a swing trader plugs in the needed calculations to identify pricing patterns, he or she is not necessarily interested in how a company is structured, whether or not the CEP is up to job, or if the company is in pitch-perfect operational model. Instead, the trader is leaning heavily on stock market algorithms that impact share pricing, digging deeply into market machinations that might impact the price of the stock going forward.

In short, good technical analysis that racks pricing movements from market buyers and sellers helps a swing trader make smarter, more informed trading decisions.

By a proper understanding of market perceptions toward a stock, especially in regard to future valuations, swing traders can lock into a security's current price and its future value. In doing so, a trader can identify any potential divergence between the two factors that might lead to a solid return on investment.

In forex trading, technical analysis refers to the framework used by most trades to study the movement of prices, especially for short term traders. The theory behind technical analysis is that one can

predict the current trading conditions and possible future price movements form analyzing the past price movements. Theoretically speaking, the main support of technical analysis is that the prices absorb all the information in the market. If therefore the prices reflect all the information that has affected the trade, then one can use price action to trade. History tends to repeat itself and technical analysis follows the saying. Technical analysts study the charts and history to identify the patterns that are similar and traders use the information with the belief that the currencies will act the same as the past.

Technical analysis involves studying the past price actions in an effort to identify similarities and drawing conclusions on the possible future movements. The nature of the forex market is that it operates 24 hours a day, therefore, there is a lot of information and data that one can use to analyze the future price movements. The information used during technical analysis is statistical and the data being analyzed can be visualized and quantified using graphs and charts. The traders and analysts use indicators, technical studies, and other tools of analysis to gather the information. Summarily, technical analysis follows two things 1) identifying the trends, and 2) identifying resistance/ support through the analysis of timeframes on the price chart. The forex market can only move in three directions namely up, down or sideways. The prices typically follow a zigzag trend and consequently, the price action can only have two states; the range and the trend. The range is when the price zigzag moves sideways while the trend is when the zigzag goes high (bull trend/ uptrend, or when it goes down (bear rend/ downtrend)

The benefits of technical analysis

The main importance of technical analysis is that a trader can determine the where and when of entering or exiting the market and more so the latter. Some people say that one cannot get any value from analyzing the historical prices. Such traders follow the random walk theory whereby all markets are efficient and they respond to changes in a random manner, therefore, one cannot predict the future. Great investors including Warren Buffett heavily dispute the random walk theory and state that it is almost impossible for markets to be fully efficient. Inefficiencies are the

opportunity makers that help the traders to capitalize on the movement of prices in the forex trade. Analyzing price action using technical analysis tools helps one to make more informed decisions while trading.

The financial markets such as foreign exchange are not easy to analyze. These markets are influenced heavily by a wide selection of factors such as the monetary policies made by the central banks, governmental fiscal policies and other internal factors determined by the consumers and producers. Analyzing all the different factors and identifying how the influence the assets in the market can be a tough task. It is equally important that we note the ease at which a trader can make errors when analyzing a large number of factors. This particularly affects the inexperienced traders and those who have limited focus and time. The technical analysis helps the trader to focus on just one piece of crucial data which is the price movement. Analysis offers traders a way of judging the charts, identifying potential trade setups, and managing them.

Indicators of Technical Analysis

Technical indicators are used to mathematically analyze the connection between different elements on a chart to help traders predict the future prices. Many trading platforms have the indicators programmed on to their bodies. The most popular technical analysis indicators include:

Trend indicators: Average Directional Index (ADX), Moving Average (MA), Moving Average Convergence/Divergence (MACD), Ichimoku Kinko Hyo, and Parabolic SAR Indicator

Momentum: Relative Strength Index (RSI), Williams percent range (percent R), and Stochastic Oscillator

Volume: Money Flow Index, On-Balance Volume, and Accumulation/ Distribution line

Volatility: Average True Range (ATR), Standard Deviation, and Bollinger Bands (BB)

How to use technical analysis

One of the theories of technical analysis is that all markets are chaotic therefore no one is sure of the changes that will occur next

but the patterns of price movement are not absolutely random. This is to say that on every chaotic situation there is an identifiable pattern that repeats itself in most cases (mathematical chaos theory).

The type of chaotic behavior observed in the forex market can be illustrated as that in the weather forecast. No one can say for sure that certain conditions will precede but they can identify the probabilities and use them to draw almost true conclusions. A trader will admit that he or she has no guarantee in predicting the true price movements. As such, one should understand that successful trading is not all about being accurately right, it is about determining the probabilities and making trades when the odds are favorable. One part of determining the probabilities involves predicting the expected direction of the market. The next step involves predicting the entry and exit points. However, the trader should not forget the risk-reward ratio.

Although traders use the technical analysis indicators, there is no magical combination that can guarantee a trader full time wins. Some of the secrets identified by traders and analysts as keys to successful trading include good risk management programs, the ability to stay rational, and high-level discipline. Every trader can predict right and win but it will not always be the case. If a trader does not have a good risk management strategy, he or she will not stay profitable in the long term even if they conduct a thorough technical analysis.

The Moving Average Convergence Divergence (MACD) is an oscillator-type indicator that is widely used by traders for technical analysis (TA). MACD is a trend-following tool that utilizes moving averages to determine the momentum of a stock, cryptocurrency, or another tradable asset.

The Moving Average Convergence Divergence indicator tracks pricing events that have already occurred and, thus, falls into the category of lagging indicators (which provide signals based on past price action or data). The MACD may be useful for measuring market momentum and possible price trends and is utilized by many traders to spot potential entry and exit points.

Before diving into the mechanisms of MACD, it is important to

understand the concept of moving averages. A moving average (MA) is simply a line that represents the average value of previous data during a predefined period. In the context of financial markets, moving averages are among the most popular indicators for technical analysis (TA) and they can be divided into two different types: simple moving averages (SMAs) and exponential moving averages. While the SMAs weight all data inputs equally, exponential moving averages assign more importance to the most recent data values (newer price points).

How MACD works

The MACD indicator is generated by subtracting two exponential moving averages to create the main line (MACD line), which is then used to calculate another exponential moving average that represents the signal line.

In addition, there is the MACD histogram, which is calculated based on the differences between those two lines. The histogram, along with the other two lines, fluctuates above and below a centerline, which is also known as the zero line.

Therefore, the MACD indicator consists of three elements moving around the zero line:

- The MACD line (1): helps determine upward or downward momentum (market trend). It is calculated by subtracting two exponential moving averages.
- The signal line (2): an exponential moving average of the MACD line (usually 9-period exponential moving average). The combined analysis of the signal line with the MACD line may be helpful in spotting potential reversals or entry and exit points.
- Histogram (3): a graphical representation of the divergence and convergence of the MACD line and the signal line. In other words, the histogram is calculated based on the differences between the two lines.

The MACD line

In general, the exponential moving averages are measured according to the closing prices of an asset, and the periods used to calculate the two exponential moving averages are usually set as 12

periods (faster) and 26 periods (slower). The period may be configured in different ways (minutes, hours, days, weeks, months), but this article will focus on daily settings. Still, the MACD indicator may be customized to accommodate different trading strategies.

Assuming the standard time ranges, the MACD line itself is calculated by subtracting the 26-day exponential moving average from the 12-day exponential moving average.

MACD line = 12day exponential moving averages-26day exponential moving averages

As mentioned, the MACD line oscillates above and below the zero line, and this is what signals the centerline crossovers, telling traders when the 12-day and 26-day exponential moving averages are changing their relative position.

The signal line

By default, the signal line is calculated from a 9-day exponential moving average of the main line and, as such, provides further insights about its previous movements.

Signal line = 9 day exponential moving averages of MACD line

Although they are not always accurate, when the MACD line and signal line cross, these events are usually deemed as trend reversal signals, especially when they happen at the extremities of the MACD chart (far above or far below the zero line).

The MACD histogram

The histogram is nothing more than a visual record of the relative movements of the MACD line and the signal line. It is simply calculated by subtracting one from the other:

MACD histogram = MACD line - signal line

However, instead of adding a third moving line, the histogram is made of a bar graph, making it visually easier to read and interpret. Note that the histogram bars have nothing to do with the trading volume of the asset.

MACD settings

As discussed, the default settings for MACD is based on the 12, 26, and 9-period exponential moving average-hence MACD (12, 26, 9).

However, some technical analysists and chartists change the periods as a way to create a more sensitive indicator. For example, MACD (5, 35, 5) is one that is often used in traditional financial markets along with longer timeframes, such as weekly or monthly charts.

It is worth noting that due to the high volatility of cryptocurrency markets, increasing the sensitivity of the MACD indicator may be risky because it will likely result in more false signals and misleading information.

How to read MACD charts

As the name suggests, the Moving Average Convergence Divergence indicator tracks the relationships between moving averages, and the correlation between the two lines can be described as either convergent or divergent. They are convergent when the lines gravitate toward one another and divergent when they move apart.

Still, the relevant signals of the MACD indicator are related to the so-called crossovers, which happen when the MACD line crosses above or below the centerline (centerline crossovers), or above or below the signal line (signal line crossovers).

Keep in mind that both centerline and signal line crossovers may happen multiple times, producing many false and tricky signals- especially in regards to volatile assets, such as cryptocurrencies. Therefore, one should not rely on the MACD indicator alone.

Centerline crossovers

Centerline crossovers happen when the MACD line moves either on the positive or negative area. When it crosses above the centerline; the positive MACD value indicates that the 12-day exponential moving average is greater than the 26-day. In contrast, a negative MACD is shown when the MACD line crosses below the centerline, meaning that the 26-day average is higher than the 12-day. In other terms, a positive MACD line suggests a stronger upside momentum, while a negative one may indicate a stronger drive to the downside.

Signal line crossover

When the MACD line crosses above the signal line; traders often interpret it as a potential buying opportunity (entry point). On the other hand, when the MACD line crosses below the signal line,

traders tend to consider it a selling opportunity (exit point).

While the signal crossovers can be helpful, they are not always reliable. It is also worth considering where they take place in the chart as a way to minimize the risks. For instance, if the crossover calls for a buy but the MACD line indicator is below the centerline (negative), market conditions may still be considered bearish. Conversely, if a signal line crossover indicates a potential selling point, but the MACD line indicator is positive (above the zero line), market conditions are still likely to be bullish. In such a scenario, following the sell signal may carry more risk (considering the larger trend).

MACD and price divergences

Along with centerline and signal line crossovers, MACD charts may also provide insights through divergences between the MACD chart and the asset's price action.

For example, if the price action of a cryptocurrency makes a higher high while the MACD creates a lower high, we would have a bearish divergence, indicating that despite the price increase, the upside momentum (buying pressure) is not as strong as it was. Bearish divergences are usually interpreted as selling opportunities because they tend to precede price reversals.

On the contrary, if the MACD line forms two rising lows that align with two falling lows on the asset price; this is considered a bullish divergence, suggesting that despite the price decrease the buying pressure is stronger. Bullish divergences tend to precede price reversals, potentially indicating a short-term bottom from a downtrend to an uptrend.

Overview

When it comes to technical analysis, the Moving Average Convergence Divergence oscillator is one of the most useful tools available. Not only because it is relatively easy to use, but also because it is quite effective at identifying both market trends and market momentum.

As most Technical Analysis indicators, however, the MACD is not always accurate and may provide numerous false and misleading

signals-especially in relation to volatile assets or during weak-trending or sideways price action. Consequently, many traders use MACD with other indicators - such as the RSI indicator - to reduce risks and to further confirm the signals.

Conclusion

Thank for making it through to the end of Swing Trading, let us hope it was informative and able to provide you with all of the information you need to become a successful swing trader.

Let me assume it has provided you with all the secrets that you need to get started on swing trading. Besides, I hope that the information will help you achieve your goals regardless of whatever they are. Just because you have read the book to the last page it does not mean there is nothing else left to learn in swing trading. The only way to find the mastery skill you seek is by expanding your knowledge.

The next step is to do whatever is needed to ensure that you succeed. With swing trading, you cannot stop reading and gathering new information every day, keep the book close for reference and check out other sources of information. You will realize that you still need help opening new trades, choosing trading styles, and strategies among others even after reading this book. As such, you will most likely achieve excellent results by keeping records on what you have learned.

Since you have completed your first step, it is vital to understand that it is just a preparation, a part of the bigger picture. Your highest chance of overall success will come from taking the time to analyze and learn as many essential trading skills as possible. Only by using this book as a springboard to greater achievements will you be able to trade well, knowing that the book has prepared you for every challenge that the world presents to you.

Finally, if you found this book wonderful and beneficial in any way, please leave a review on Amazon. I will highly appreciate.

ALGORITHMIC TRADING

A Beginner's Guide to Learning the Fundamentals and the Strategies of Algorithmic Trading

Introduction

Congratulations on downloading Basics of Algorithmic Trading (With Examples), and thank you for doing so. You will not regret your decision. This book is a basic review of the fundamentals of Algorithmic trading and gives you an insight into what it is, how to succeed and the importance of successful backtesting.

The objective of this book is to educate anyone interested in Algorithmic trading. It aims to introduce you to Algorithmic trading then takes you through the various concepts.

Trading the markets have been around for a long time, but you cannot appreciate where it has come from unless we look at the history, which is presented in the first chapters of the book. We go ahead to look at the different people that make use of the trading strategy and how they use it.

Each trading strategy comes with a real-world example to make sure you get the concept right. Thank you for reading.

Who Should Read this Book?

Algo trading encompasses trading, computer programming, and quantitative analysis. Thus, this book is aimed at all three areas. This should serve as a good introduction for any investor, seller, salesperson, and quant or software developer looking to get more information in these fields.

The book aims to take the reader from the ground up, so you don’t need to have advanced knowledge of the markets to enjoy the book.

Chapter 1:
Algorithmic Trading Intro



Algo trading is an essential tool for electronic trading of financial assets. Algorithmic strategies are also vital to the process of coming up with trading goals and investment strategies for many traders.

Currently, there is a wide array of assets that you can trade electronically from the comfort of your home or from an office. These range from stocks to bonds, cash to certificates and a variety of other assets that can be bought and sold at the tap of a button. The technology that is in place to achieve this is relatively new, though the fundamental market mechanics remain the same. Overall, trading is all about trying to get a buyer quickly and make a profit while at it.

Algorithmic trading, also called algo trading, black box trading or automated trading, refers to a technological advancement in trading that has been witnessed in the securities market. The process runs on a computer that has to implement a specific set of instructions (the Algorithmic) that you come up with. This Algorithmic places a trade that results in profits at a frequency and speed that isn't possible for human traders.

Algorithmic trading has taken the global market by storm. For most countries, Algorithmic trading is now the mainstream technique

that traders use to trade faster and make profits. In fact, most traders that have used algo trading say that they cannot use any other method unless it offers better incentives than algo trading.

Algorithmic trading has taken precedence over other forms of trading and has been accepted by many countries, including the United States, the United Kingdom, and South Korea. The main features that make this trading method adopted by these countries are the liquidity and exceptional speed of trading that the method brings to the table.

This trading method is expected to be adopted more during the forecast period between 2018 and 2026. This is true due to the increased adoption in the use of cloud computing.

You might wonder why traders opt for cloud computing, yet it is known to be capital intensive. Well, traders can now utilize the computing technology to build their own data centers so that they can store their data, back it up and recover it. Cloud computing also allows traders to manage data in real time and network with other traders. It is also easier to rent space in the cloud as compared to developing a software infrastructure.

Statistics show that the cloud computing market is expected to grow to $US 191 billion by 2020, up from $58 billion in 2013. The increased adoption of cloud computing is attributed mostly to Algorithmic trading.

This type of trading offers numerous advantages besides the typical ability to come up with a strategy in advance. For one, you don't have to be emotionally involved with the trade at all, a fact that has been known to be the primary source of burnout for many talented traders. You end up saving a lot of manpower in the process as well.

Where Can Algo Trading Be Utilized?

- Mid to long term investors who deal in mutual funds, pension funds, and insurance can use algo trading systems to purchase stocks in considerable quantities to influence stock prices with significant volume investments. Trading via Algorithmic platforms needs the investors to first specify the trading goals in the form of mathematical instructions that can be simple or highly sophisticated.

After defining the instructions, the computers go ahead to implement these trades using the underlying commands.

- Market makers, arbitrageurs, and speculators can benefit significantly from automated trading by determining the right time to place a trade so that they do not make losses. These use computerized algorithms to provide the proper liquidity to the market. As such, the parties end up cutting costs of hiring additional traders. Additionally, these broker-dealers can use the algorithms to transact on behalf of their investor clients. The buy-side needs information from the sell-side on how much needs to be invested (capital and transaction costs) as well as point out any issues that might arise during execution.
- Trend followers, pair traders, and hedge funds can program their trading rules and allow the trade to run automatically. This saves them time and effort while giving them more returns on the same.
- Company managers can use Algorithmic in a wide variety of ways. They can use them to manage funds – index and mutual funds, quantitative funds, and pension funds, as well as hedge funds. Using these tools, they can go ahead to implement various investment decisions. The algorithms determine the best ways to make decisions – including the appropriate price, purchase time, and quantity of shares that can enter the market.

Algo Trading and Retail

Many retail traders get into the market knowing too well that the competition is high. The competition doesn't arise from other retailers but from wholesalers and multinational corporations with huge capital outlays.

The good news is that retail algo traders have the capacity to compete with other players on the market, though this comes with many disadvantages:

- The capacity – retail traders have greater freedom to trade in smaller markets. They get to generate more revenue in these spaces.
- Crowded trades – many funds suffer from high turnover,

which means they don't have consistency in their trades.

- Low capital base – when playing in huge markets, retailers with low capital bases reduce the impact on the market significantly.
- Liquidity – many retailers don't have access to prime brokerages, instead, they have to do with "other" brokerages that aren't as efficient as the major ones.
- Lack of information flow – the biggest disadvantage for the retailer is the lack of access to news from their brokerage.
- Poor risk management - Retailers also have a different approach to risk management compared to the quant funds. Additionally, they don't have a risk management budget imposed beyond what they determine by themselves. They also don't have a department that enforces this.

Algorithmic Trading Statistics

To understand the role and position of Algorithmic trading in the economy better, it is vital to look at various statistics that define the model.

Algo Trading Dominates 80 Percent of the Stock Market

Studies show that 80 percent of all the daily trades in the US stock market is led by automation. This is due to the use of machines to come up with predictions based on real-time data releases.

At the start of the new millennium, Algorithmic trading consisted roughly 15 percent of the total trade volume in the country. However, this has changed, and at the moment, algo trading is widely used in huge institutional firms that command over 80 percent of the US market as indicated in the table below:

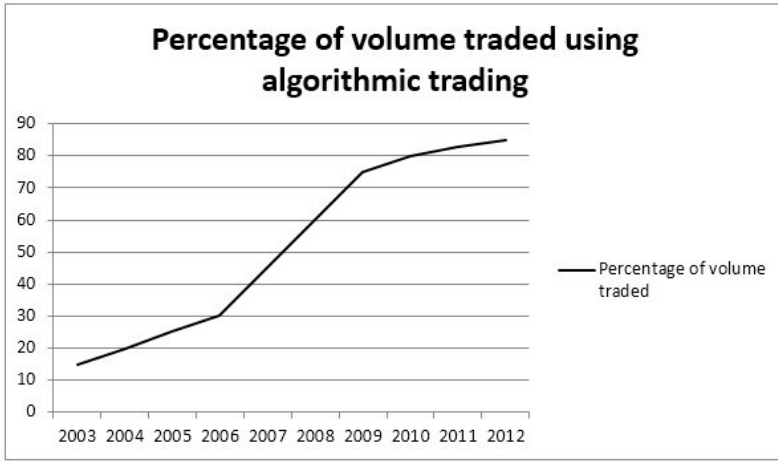


Table *1.0: Percentage volume traded using algo trading between 2003 and 2012. Data courtesy of arno.uvt.nl*

All is due to the evolution of technology

The growth of Algorithmic trading is attributed to the rapid development of technology. Some of the most notable mentions include:

- The evolution and improvement in cloud services have revolutionized algo trading.
- The potential opportunities that have come up due to development of blockchain technology.
- The growth witnessed in artificial intelligence and the availability of machine learning in financial markets.
- The increase in research into technology.

A recent report shows that the use of Algorithmic trading systems will rise by 10.3 percent between 2016 and 2020. The trading market size is also expected to grow from 11.1 billion USD in 2019 to a staggering 18.8 billion USD in 2024. The major growth stimulators include the increasing demand for effective execution of orders and a reduction in transaction costs.

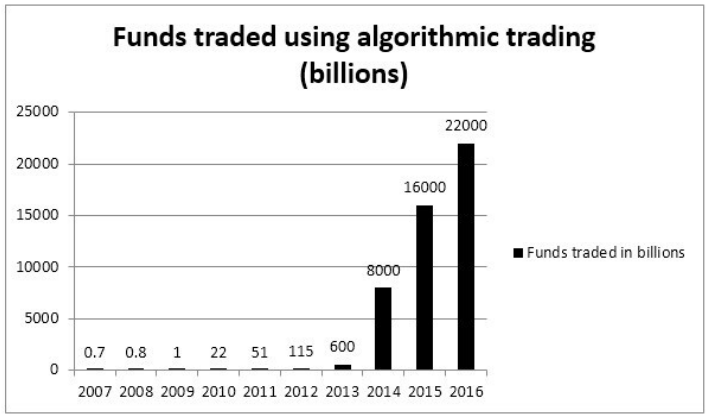


Table 2.0 *Shows funds (in billions) traded over a period of time .*

Differences between Algorithmic, Quantitative, and High-Frequency Trading

Let us look at the three trading aspects – Algorithmic, quantitative, and high-frequency trading.

Algorithmic Trading

As discussed in previous sections, this is simply the act of turning a trading idea into a trading strategy using an Algorithmic. The strategy created can be backtested to prior data to confirm whether it can give good returns when applied in real markets.

Since we shall look at Algorithmic trading on a deep level, we shall not delve so much into it but will look at the other two and point out the differences that arise.

Quantitative Trading

This form of trading relies on quantitative analysis that fully depends on number crunching and mathematical computations to come up with trading opportunities. The most common inputs used in this case are the price and volume of assets. These two are then used to come up with mathematical models.

Major financial institutions, as well as hedge funds, use this trading strategy. Transactions, in this case, are usually large and involve the sale of thousands of shares. Individual traders are increasingly

adopting this trading model as well.

Quantitative trading techniques typically have short-term investment horizons. The significant advantage of quantitative trading is that you get to use backtested data and eliminate decision-making based on emotions. However, the major disadvantage is that the method loses its effectiveness whenever conditions change.

The distinguishing feature of this form of trading is that it removes any subjectivity, which means the trading decisions are made based on information that can be quantified. As expected, the decisions that are made by the trader are based on a sort of statistical or mathematical model of the market behavior.

You can use one of the many models of market behavior; however, finding the right one that is accurate enough to give you the expected profits is not an easy thing at all. We can come up with models that are based on fundamental data, which refers to information that affects the direction of the market. Such information can be news releases or company information that gives you numbers to work with.

High-Frequency Trading (HFT)

This is a trading program that makes use of powerful computers to trade a large number of orders within seconds. The program utilizes complex algorithms that go ahead to analyze multiple markets and implement trades based on the prevailing conditions. The basis is that the faster the execution speed of the trade, the more profitable compared to traders that have slower execution times.

The major advantage of the strategy is that it has removed bid-ask spreads and improved liquidity.

The most significant disadvantage is that it replaces a number of human-intervention in trading and replaces them with mathematical models to make decisions. Decisions happen so fast that most of the time, big market decisions can happen without any reason at all.

Additionally, it has been pointed out that large companies benefit greatly when they use the trading strategy at the expense of the smaller businesses.

HFT is largely signal-based, which means something has to occur to

trigger a buy or sell signal.

Chapter 2:
History of Algorithmic Trading

The word “Algorithmic” can be traced back to circa 820 AD when a Persian mathematician, Al Kwharizmi, who was living in the country, which is now known as Uzbekistan, came up with a treatise that became the foundation for calculating with Arabic numerals. The mathematician is also credited with coming up with the word “algebra,” which stands for “putting together.”

The initial term was “algorism,” but after numerous translations in the 12th century, became the common word that we know today as “Algorithmic.”

The term Algorithmic and the concept behind it refer to several disciplines that give the basis for the computation of numbers and the creation of programs. The ensuing disciplines are many, and discussing them can take the whole of this book. What we shall look at instead is a short history of the disciplines.

The earliest known surviving description of this concept is found in Euclid’s Elements that was published in 300 BC. The Algorithmic gives an efficient way to compute the greatest common divisor, which makes it one of the oldest formulas that are still in use.

With the Algorithmic in place, it was now easy to integrate it into trading systems. The first application of the Algorithmic can be traced back to the first hedge fund in the world, which was set up in 1949 by Alfred Winslow Jones. Alfred used algorithms to balance short and long positions simultaneously in 70:30.

This advanced and in the early 1960s, some technologists took advantage of the advent of computer technology to analyze price movement in trading on a long-term basis. In the late 1960s, Peter N. Haulan is credited to be the first person to analyze stock data using algorithms; he started using exponential moving averages to determine stock data. He went on to publish the Trade Levels Reports.

Come the 1970s, and the world saw the real beginning of Algorithmic trading. This is the time when “pair trading: came to the fore. This was the brainchild of a few scientists including Morgan Stanley, Nunzio Tartaglia, and Gerald Bamberger. Shortly

after its inception, Pair Trading became so profitable that nearly every trader on Wall Street was using it. These traders made use of computer technology to have a competitive edge over other traders in the market.

As computer technology took over the world, and more powerful computers came up, the use of Algorithmic trading became irresistible. After this, all major trading platforms were running trading algorithms.

To place them strategically to take advantage of algo trading, investors are adopting algo trading platforms faster. With computers able to digest large quantities of data and being more adept at running complex calculations and being able to react to changing marketing conditions, the algos are the best bet when it comes to real-time trading needs for the current challenging market climate.

Algo trading became more popular during the early 2000s. By the year 2005, the trading mechanism accounted for nearly 25 percent of the total trading volume. By 2009, the trading volume had grown threefold to 75 percent of the total trading volume. This was attributed to the increased difficulty that traders were experiencing when executing orders.

The decade between 2000 and 2010 was associated with changing investor styles as well as differing market participants. For instance, between 2003 and 2004, mainly asset managers, taking over 40 percent of the trade volume, ran the market volumes. In 2003, high-frequency traders had 10 percent in total market volume.

Things have changed since then, and many conditions have changed. This has seen the rise in algo trading. Many companies have come up with research materials on the same, though a huge chunk of the industry has come from broker-dealers who are in the thick of things.

Chapter 3:
Basics of Algorithmic Strategies
Who Uses Algorithmic Trading Strategies?

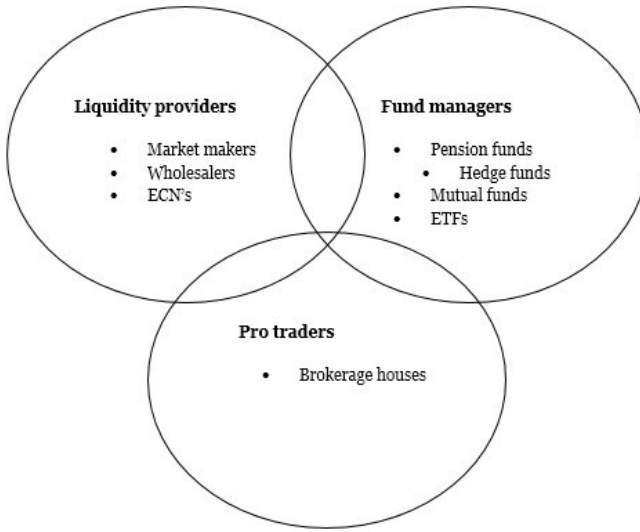


Chart 1.0: *how the various users overlap.*

As of 2019, Algorithmic trading has become a mainstay of the financial industry. Previously, the technology used to be exclusive for big brokerages and banks, but now the use of the strategy is commonplace, with small brokerages taking advantage of this profitable strategy.

Secretive hedge funds form one of the biggest users of algos due to the competitive advantage the technology gives them over other traders. With little regulation towards their activities, these funds take advantage of the technology without having to divulge what they are doing.

The dream for every trader is to have an Algorithmic that works fast and gives a high return on investment, with a competitive advantage over their competitors. This means the hedge funds enjoy constant returns while they vigorously protect their secrecy.

Have you ever wondered what makes major hedge funds to produce extraordinary returns on their capital investment year in year out?

Well, each of the hedge funds you see employs tens of statisticians, mathematicians, and physicists that run advanced computer software geared towards generating algorithms.

The second group that uses Algorithmic trading includes major brokerages and banks. The players in this group have recognized the value of Algorithmic trading. These firms have human and financial resources that make sure the Algorithmic runs the right way. These companies deploy whole teams made up of carefully chosen employees who are tasked with making sure they assess the situation, come up with Algorithmic strategies, and then analyze the results.

However, the information about successful algos isn't divulged to the public or rival companies. You will find that the algos used by the companies are a closely guarded secret. Each firm has algos that are specific to their operations, and they keep these algos in vaults with each user having his or her implementation to keep a secret.

However, the algos are in constant evolution and adaptation. Firms and companies are looking for better ways to use the increasing computer power and to make sure that they have a competitive edge over their rivals.

Individual traders aren't left out as well. However, there is very little data on the level of activity, the frequency, and the number of individual traders that use algos in their trading activities. Studies show that over 8 million individual traders in the USA directly use the algos in trading. However, there aren't clear statistics to show how many people use the tools.

Why Have Algos Become Mainstream So Quickly?

This is a question that is running through your mind at the moment – why is algo trading becoming more and more common, and why is it growing stronger by the day?

Wall Street is known to quickly grab any possible edge to give them a competitive advantage. There have been trading methods in the past that have come so rapidly and in the same way, rapidly fizzled out. However, the adoption of algo trading came rapidly, but it has withstood the test of time with no indication of slowing down soon.

Let us consider the reasons for the explosion of the strategy. We shall first look at technical reasons then go ahead to consider conceptual reasons

1. Computational Power

This is obvious. Traditionally, you had to compute the trades manually, which took time and emotional drain. The computational power of algorithms has worked as per Moore's Law, and at the moment, you can process data faster. Individual computers have high computational power that makes them process data as fast as NASA equipment.

Additionally, computers can now process huge amounts of data fast, meaning that they can scan hundreds of markets at the same time while looking for trading opportunities. Human traders cannot keep up with such kind of workload.

Computers are also not prone to execution difficulties that are faced by humans – calculation errors especially form a huge obstacle for traders that rely on the human capacity to make decisions.

The computers have no emotional attachment to the market or trade, either there is a trade opportunity to take up or there isn't. They also have the capacity to execute commands continuously and consistently. Compare this to a human who is limited to only a few hours of running commands each day, who has a social life and suffers from fatigue time and again.

2. Growth of Telecom

Additionally, the telecom side has grown dramatically with the world being interconnected using fiber optics. The bandwidth has grown exponentially due to the growing requirements of computational power. When you have faster computational power and wider bandwidth, you can run your trading programs faster than ever.

3. Growth of Infrastructure Industries

The growth of infrastructure industries has also contributed to the stability and reliability of the increase in trading. Algorithmic strategies contribute to the success of the industries that focus on trading. With such companies in place, implementation of the

strategy becomes easy.

Remember that to implement the trading, you need to make sure you have a healthy supply of capital and put together a team of technologists, traders, and market analysts to run the strategy. You also need a strong IT component that these industries can supply.

The industries give you the capacity to mold the Algorithmic into an operational component of the entire system. This wholesome component does not only deliver the tools you need for computation but also gives you the awareness for the process to operate so that it can adapt to changes. You thus keep ahead of the regulatory changes and the competition.

How the Algo Trading Team Works

Here is a scenario that is common among many implementation teams:

The Algorithmic designer comes up with a trading idea, however, complex it is. The strategy might need lots of thoughts, and he goes ahead to mull over it, at times for weeks or months. The design might be mulled over by a single designer or a team. It might be a team effort with each department being represented. At times, the CEO has a strong hand in the development of the vision.

When the designers are satisfied that they have something to offer, they turn the specification to the programmers who then convert it into software that can be executed. Execution is all about coding and optimization. The resultant software becomes fast and reliable.

After the coding, comes the dreaded testing to see how the new platform works. The team tests the Algorithmic on historical data to see how different it would have run. The efficacy of this system is tested over weeks or even months, with the test results being compared to known benchmarks.

When it becomes evident that the system will work, it is further tested before it becomes “live.” The main aim is to make sure the algo does exactly what it is meant to do, and nothing else. This is true for all market conditions as well as circumstances that the algo can encounter.

Once the Algorithmic is ready, it is deployed to the trading

department, and it is now able to carry out the various tasks fast, over the many thousands of stock. Therefore, the initial thought is taken; developed and packaged into an Algorithmic that is easy to use that results in accurate projection.

Deployment isn't the final step though; the head of trade and CEO, as well as the whole team, get involved in refinements and further improvements as the marketing environments change.

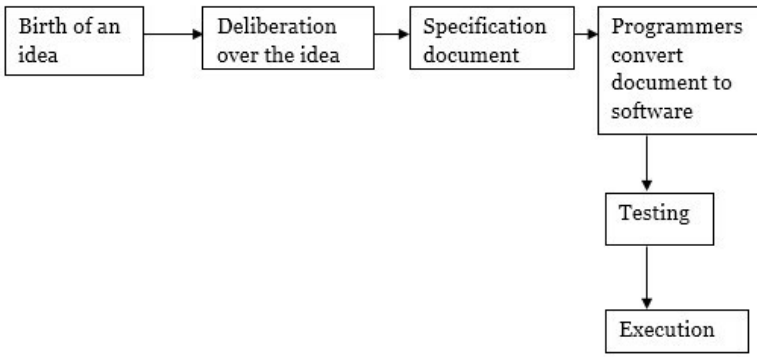


Chart 2: *Flowchart showing the process of strategic design*

Advantages of Algorithmic Trading

Algorithmic trading gives you a host of benefits that you can enjoy as a trader. Let us look at the benefits first

1. Reduce Time and Effort

If you are a beginner in the trade market, or you have been in the market for ages, you need to consider using Algorithmic trading to reduce the effort and time you have to invest in while enjoying maximum profits.

You cannot compare Algorithmic trading to any other service or a broker as the software tracks the trading market and can auto-trade while you are doing other chores or you are sleeping.

All the prices for various stocks and commodities are patterned in charts and graphs, meaning the system can easily predict the outcome of the market. However, if done manually, the process takes time, reducing the chance for brokers to act decisively on any project. Combining the algo platform and the analysis reduces any

time wasted since the system automatically studies the patterns and makes recommendations in a shorter time, making it easier to grab opportunities.

2. Eliminates Emotional Trading

Many traders fail because they use emotions while trading, which is a bad practice. On the contrary, algo trading solutions follow the existing trends and react the way they are programmed. This means they focus on using facts to return massive profits. They run fast and respond in real time, thus don't miss any deals that might exist at that particular time.

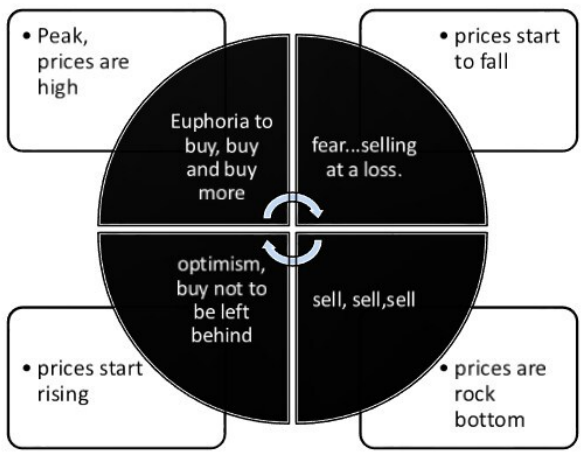


Chart 3: *The various emotional reactions by traders*

The systems keep track of the market 24/7, which is not possible for a human trader or broker. Accuracy is also a plus because they use inbuilt computational models to come up with the right forecast. This makes the systems reliable regardless of the trading environment.

3. Easy to Use

Many traders opt for the systems because they are easy to use and come with unlimited benefits to the trader. You don't have to sit up all night monitoring trends on the market, analyzing trends, and performing complex calculations all in the aim of implementing a trade. You don't have to decide when to buy or sell; instead, all you have to do is customize the options and then leave everything to the

system.

The system is programmed to trade as per the instructions you give them. You get to program the system so that the rule of trading is always followers – to buy low and then sell high. Many traders and brokers are opting for trading because it gives them the best profitability while reducing the time that is spent on the whole operation.

4. Increased Efficiency

The other side of trading systems is the lack of emotional decisions that are a limitation of most traders. Even part-time traders get to do a fulltime job when using the system because it trades on their behalf. The trading system on which the algo is based makes sure that it removes any limitation of the human mind, which means increased efficiency.

It is almost impossible for a human mind to go through all the steps and every detail of each trade accurately. To ensure efficiency and accuracy, the systems are put in place. These systems are also efficient for multiple trades. You can now get into more than one trade while maintaining the necessary efficiency and accuracy.

5. Access to Real-time Data and Information

The algo trading system uses computers that utilize mathematical models to analyze data that it receives from various sources before executing the order (buy or sell). Technical analysis gives the information that is received from key indicators of Algorithmic trading.

Technical analysis is used to check for an existing pattern. The existing pattern arises from a view of the past movement of stock that are of interest to the company. Many brokers or traders believe that history tends to repeat itself, especially when it comes to trading. Therefore, many traders check at the history of the stock and past prices then come up with a forecast.

This information is used by the algo system to give you the current decision. Remember that a decision based on facts and trends is more valuable than any decision you can take based on emotions.

6. Accuracy of Results

Accuracy is an important aspect of any trading system. Accuracy results in better results when it is incorporated in the trading system. The use of computers in coming up with forecasts and placing trades helps reduce mistakes that are associated with running the activity manually.

If you are running a trade manually, the chances of buying the wrong currency pair or commodity for the wrong amount are very high. When using a computer Algorithmic, you have little or no time for making mistakes.

Many mistakes come about due to human emotions coming into play when placing a trade. Humans often get affected by their emotions that usually lead to making irrational decisions that lead to losses. With a system in place, you can remove any errors meaning you can start trading in a live market much faster.

Trading manually leaves a lot of room for a trader to be carried away by greed while being overwhelmed by fear.

7. Reduced Risk of Losing Cash

To trade the markets accurately, Algorithmic trading lets you run backtests. This is a huge task since, as a trader, you need to know the kind of technique that works or doesn't work for you. Algo trading allows you to backtest the systems and get to know what worked or what failed. This helps you make an income while reducing the risk of losing cash.

8. Reduced Costs of Operation

Finally, yet importantly, using algo trading reduces the chances of losing your earnings. You don't have to spend a lot of your time checking out the market since the trading can happen without your physical presence. The time you spend on monitoring the market is reduced drastically, allowing you to engage in many activities.

9. Historical Assessment with Future Prediction

This is the most vital advantage in creating an automated strategy. When you have an algo trading system in place, you can ascertain the performance of the market depending on historical data, which might be representative of future market processes. This process is technically known as backtesting. Backtesting allows statistical properties of any strategy to get determined, subsequently

providing insight into the profitability of a strategy.

10. No Discretionary Input

Another major advantage is that you have no provision to modify the data at the point of execution or during the process in position.

11. Allows for Comparison

One of the major advantages of using an automated trading system is that you can determine the risk, equity growth, and trading frequency plus a myriad of other aspects. This allows you to compare various strategies such that you can allocate capital optimally.

12. Lower Commissions

Commissions that are paid during trading are much lower than traditional commission fees. This is because algo trading provides the investors with services that are related to the execution of the trade. However, the commission you pay varies from one provider to another.

13. Anonymity

Orders that you enter into the system and that you trade via computer are traded automatically. The orders don't have to be shopped across trading floors like before, which in turn maintains your anonymity.

14. Control over the Whole Process

Buy-side traders hold full control over the orders they execute. Traders have control over what to do – when to accelerate and when to reduce trading based on the objective of the investor as well as the prevailing market conditions. A trader can choose to cancel the order or modify the instructions in real time.

15. Minimal Information Leakage

The broker doesn't receive any information regarding the order or the intentions of the investor. The buy-side investor goes ahead and specifies the trading instructions by adding the necessary commands to the system.

16. Transparency

Investors can understand what happens regarding the execution of the order. Since the rules of the Algorithmic are given to the investor in advance, the investor knows how the tool will run and what to expect.

Disadvantages of Algorithmic Trading

Although algo trading provides a host of benefits to the trader, there are a few downsides you need to know as well. These include:

1. High Resource Demands

This is one of the biggest disadvantages of algo trading. You need to have technical resources to make it work for your company or firm. You need to have the following:

- Software architecture: this is the infrastructure that components providing the trading functionality is deployed and executed. The software system you install needs to be functionally operational. The software architecture should also meet user expectations. The architecture needs to get market data, define the trading strategy, and analyze the securities against the strategy.
- Physical network constraints. These factors constrain the physical architecture. The physical architecture is the one that holds the software that you run to implement trades. This includes computer hardware as well as network related components.
- Besides, you have to obtain data feeds for the intraday quantitative strategies, especially if you plan to use futures contracts.

2. Regulatory Constraints

These come by through laws and regulations. These laws and regulations are specific in various countries. Some countries will allow you to run your architecture while some will restrict a few features. The regulations are important because it influences the design and implementation of the algo trading system. The system you come up with needs to comply with the rules that have been put down by the relevant regulatory body within the country or

state.

Some rules make it hard for you to run certain components of your Algorithmic, which means it won't work to its full potential.

3. The System Makes You Fully Reliant on Technology

While the Algorithmic trading system eliminates the negative effects of emotional trading, it also makes you reliant on technological systems. This might not be such a big issue, but challenges arise when the automated system that is in place is set up on a workstation in the office rather than on a server. In such an instance, any loss of internet connection or computer crash might prevent your trades from being executed, meaning that you miss vital market opportunities.

Even when the strategies are successfully integrated into online trading platforms and servers, you still need to at list monitor the trades to make sure they run fully.

4. Risk of Over-optimization

You also need to be aware of the risk of overoptimization, which might look great when presented on paper but fail to work in real market conditions.

With overoptimization, you end up spending a lot of time refining and cultivating the strategies based on results, only for you to find that the system in place isn't capable of performing real-time market implementations. This is the reason why test results need to be run carefully and then measured using your common sense as well as the happenings in the market as well.

5. Lack of Control

Another demerit of algo trading is the lack of control that comes with the systems. Since most of the trades are automated, then you do what the program asks you to do. You won't be able to control any losses that come your way. Additionally, the program needs to be tested extensively to avoid mistakes that might arise.

6. Amplified System Risk

Algorithmic trading, especially when it is high frequency, magnifies

the risk of trading in various ways. First, it intensifies volatility, especially when the system tries to outfox the competition. Remember that the system is made in such a way that it reacts simultaneously to the existing market conditions. Due to this, the Algorithmic is forced to take some trading positions, or might even stop trading altogether leading to losses.

7. Complacency

Users can become complacent and go ahead to use the same Algorithmic strategy just because they understand it. They do this regardless of the market conditions and the order characteristics just because they are too familiar with the Algorithmic.

8. Lack of Consistency

Users need to make sure there is consistency across the Algorithmic platform and their investment goals. Making sure consistency is achieved is difficult, especially when the actual Algorithmic rule doesn't give the transparency you expect. Some of the Algorithmic strategies come with non-descriptive names, which don't give any insight n what they do.

9. Too Many Algos to Choose From

There are too many algos and too many names for you to consider. Some of the algos have a descriptive Algorithmic name that is understandable, while others aren't as descriptive, making them hard to understand. This means that investors need to understand as well as differentiate between so many Algorithmic strategies while keeping track of changes that occur in the various platforms.

Case Histories

Epro Corp Algorithmic Trading system for Stock Broking Industry

The Client

In this case, study, the client approached the firm to implement an Algorithmic system that would provide a trading solution for their clients.

The client wished to handle the following challenges:

- Come up with a system that can integrate into their existing order management system.
- To use the existing order management system standards and API to implement the algo trading system.
- To enter the market faster using the system.
- To come up with multiple priced feed as well as destination integrations to make sure the system works perfectly across various platforms and destinations.
- Through the system, the client wished to enjoy more profit.

Technology Used

Epro Corp used Swing, Java, advanced data structures, and TCP/IP to come up with the system.

The Solution Provided

- The company came up with an algo trading system that directly plugged into the existing order management system.
- The user interface was intuitive and easy to use.
- The configuration was able to handle difficult decisions regarding trading.
- The configuration sourced information from multiple sources.

Benefits to the Client

- The client was able to generate an Algorithmic trading platform that returned high profits than ever before.
- Trades became more profitable, and the system was able to handle a higher volume of trades.
- They got more referrals and expanded their customer base.

AlgoTrader Company

The company provides an Algorithmic trading software solution to clients that use its quantitative hedge funds. Clients use the software to automate complex strategies in Forex, equity, and derivative markets. It provides these needs on an everyday basis to make sure clients get the best from their trades. The company supports over 100 trading strategies and supports over 400

exchanges and brokers.

The Need

AlgoTrader approached XICOM to help come up with trading software based on an Algorithmic to help their clients to trade better.

The Challenges

XICOM met several challenges that included:

- The client has an old site that had an outdated design that had to be updated before it could use the advanced technologies that XICOM planned to provide. XICOM had to redesign the site to the best specifications.
- The client needed the website to be responsive so that it can work on any device.
- Xicom had to maintain the plugins that were already on the site.
- The site needed rigorous and extensive testing to make sure the system was perfect.

What Xicom did

- Xicom had worked on similar projects and showed earlier projects to the client so that they knew what to expect.
- The company came up with a template to show the client.
- Xicom came up with a mockup that was approved by the client before the system was integrated into the redesigned website.
- After the design, the system was thoroughly tested, and quality assurance made to deliver the best client for the website.
- The site was made to be responsive as per the needs of the client.

Results and Benefits to the Client

- AlgoTrader clients are now able to implement trades right from their mobile devices as well.
- The product was delivered to the client on time, making sure that it was integrated into the market on time.

- The client satisfaction level was increased, and the client base expanded.

Edge Financial Technologies

The company was approached by a client to help develop an Algorithmic trading solution for their client.

The Challenge

The client was looking for a way to integrate the Algorithmic trading application into their existing architecture, and then connect the application to multiple exchanges in a quick way.

The Solution

Edge Financial Technologies went ahead to come up with a solution that connected the system to an adapter API to allow exchanges in real-time.

The Benefits

After the connection, the client enjoyed various benefits that included:

- Ability to run multiple exchanges each day faster than before.
- The application was created in line with the regulations put down by the regulatory body.
- The solution was timely, and it allowed faster integration into the market and cost savings.

The growth and future of Algorithmic trading

Therefore, we all know that Algorithmic trading is set to change the future, but before we do this, it is prudent to understand who the changes affect. Here are the major players in Algorithmic trading:

- Retailers.
- Major trading firms.
- Brokerage forms.
- Multinational investment financial institutions with expansive investments.

Let us look at a case study on the role of algo trading in upcoming

markets, specifically the cryptocurrency boom.

Case Study: Role of Algorithmic Trading in Cryptocurrency Markets

Just as an example, we want to look at how algo trading has affected trading in cryptocurrency markets. If you have been active in such a market, you must have heard of “bots” which are automated tools to trade the cryptocurrency markets.

While algo trading programs have helped shape the traditional market over the decades, it has also seen widespread adoption by crypto traders.

While these markets are still developing, they have great potential, and this is why they use these tools to realize unmitigated success in financial markets.

What is a Bot?

A bot is an automated, programmable system that monitors and shares information runs queries and performs a set of defined tasks. It is a short form for “robot,” and is widely used in technology circles. The use of bots in crypto trading can give traders more flexibility and time to handle other projects and allow for rapid information handling. This, in turn, helps traders to enjoy more profits.

The use of bots in crypto trading started a few years ago, and these monitor prices as well as exchange rates, while sending user-alerts for trading volumes, and more.

For instance, these bots can help traders to buy and sell cryptocurrency faster than ever before. They can adhere to rules that you put down, for instance, to buy low and sell high, giving you profit from the difference.

The Need for Bots

The need for using bots is necessary due to the highly volatile nature of the crypto market. Under crypto trading, markets shift so fast that when a trader doesn’t pay attention, there is a high risk of making losses on the investment.

To make money from the markets, it is vital that a trader monitors

the current market constantly so that he can act fast when an opportunity arises. Bots work by providing updated information that will keep the trader in the know at all times. The bots act as RSS for updates for crypto markets.

In addition, these bots provide algo traders access to a wide range of algo trading strategies.

Example: Use of Bots in Arbitrage Trading

One of the top strategies that traders have come to appreciate and put in effect is arbitrage trading. The process involves purchasing assets in one market, then reselling them in another market at a profit. Bots are used to identify when to buy and when to sell off the asset.

Are There Risks Associated With The Use Of Bots In The Future?

Of course, there are a few disadvantages or risks associated with the use of algo bots in trading. If you program the bot to focus on certain trades and yet the particular trade is unprofitable, the bot will not realize the mistake – it will execute your instructions to the latter. This leads to losses. This is why it is a plus to use the bot when you have experience in trading, and have extensive working knowledge of the market rather than rely exclusively on the bot.

Some of the popular crypto trading bots include:

- Haasbot: this offers various actions that include price monitoring for the user to handling trading on behalf of the user. The bot offers a variety of plans for different users, depending on the strategy you aim for.
- Tradewave: this is a programmable platform that allows traders to implement a marketing strategy as well as Algorithms to define what the bot does and what it doesn't do.
- Zenbot: this is a unique bot on the market since it allows you to handle high-frequency trading, which is not a premise for most traders. The system utilizes an open source code that can be updated or modified by anyone.
- Gunbot: this offers the user a customizable strategy to fit the individual trading method. It runs with many exchanges and gives you the option of choosing a lifetime license.

- Cryptotrader: the system uses cloud computing so that you don't have to download and install the software.

These are just a few of the top bots that you expect to come across when you decide to jump into cryptocurrency trading automation.

Conclusion

We expect the future to have many aspects that will make trading faster and better. As illustrated above, bots will make the entire horizon more competitive. As the demand for more accurate and complex trading programs and bots is driven by traders and investors alike, it is most likely that we shall see better adoption of new trading technologies in various trading platforms.

Changes to Expect From Growth of Algorithmic Trading

Faster Speeds

We expect faster speed of execution of orders due to the use of Algorithmic trading. Faster speeds mean that we get swift and efficient vigilance, a robust architecture, monitoring, and better security. The increase in knowledge and development of better languages to implement the systems makes it easy for better systems to come up.

Growing Career Opportunities

It is understood that even though these systems will become self-reliant, their functions and progress will need to be kept in check by experts, and constant evaluation will need to be performed on various dimensions. This gives rise to expanding career opportunities.

Jobs will come up in research analysis, derivatives trading, consultancy, software development, strategy analysis, risk management, trading, and electronic marketing.

Better Regulations

As at now, various regulatory bodies have come up with tenets to make sure the trading systems aren't abused at all. Regulations are there to eliminate any threats to a certain market. However, in doing so, the rules have had to stifle innovation and place checks in place to make sure the systems aren't misused.

We expect countries and various regulatory bodies to come up with strict regulations. However, the regulations will be made by experts who are well versed with the operation of these systems and that can modify the regulations as necessary.

The recent regulations in Europe have seen the encouragement of automation, regulatory improvements, and changes that have placed Algorithmic trading in good contention. This will pave the way for growth and proliferation of the systems.

Extensive Use of Machine Learning

Machine Learning (ML) adds a much-needed layer of intelligence atop the algorithm by making sure traders have powerful tools to extract trends and patterns from data that is processed across the globe. This gives you the ability to study data in real time and come up with conclusions.

Due to newer technologies becoming predominant, these intelligent machines will lead the trading evolution. ML is beneficial across various technologies that include:

- Quantum computing.
- Blockchain technology.
- Cryptocurrency.
- Cloud computing.
- Internet of Things
- Etc

The use of ML, in combination with other technologies, will make trading more beneficial. Some of the technologies that, coupled with ML, will make trading faster include:

- The use of nanotechnology in implementation of trades.
- The use of custom chips that allow high-frequency trading execution in nanoseconds. This can further evolve and attract investments in the Algorithmic trading market.
- Companies that make use of cryptocurrency will increase in number.
- Faster transmission of data that transmits information at the speed of light.

Better Trading Systems

As the trend improves and better systems come into focus, we expect better platforms to come up. These future systems will be able to study historical data much better, analyze it easily, and come up with trends that will work. It will also, using Artificial intelligence, teach itself to know what to expect in the future with ease. The systems will predict future markets easily while placing trades along multiple trades to spread the risk.

For instance, if the market isn't favoring the strategy that you have placed, the system will learn the Algorithmic and adjust your trading to other patterns that might alter the rules so that it matches the trading conditions.

Fewer Trading Errors

The system of the future will be able to check out multiple market conditions across the world simultaneously and save a lot of time. The system will eliminate any possibility of errors in the results it returns.

With fewer errors, we expect market crashes to be something of the past because the trading becomes accurate, and the system can realize the impact of a trade that has gone wrong. We, therefore, expect to eliminate certain issues such as Flash Crashes.

Chapter 4:
Classification of Algorithmic Strategies and Elements of Algorithmic Trading

Classification of Strategies

One of the top issues in the financial industry is the huge number of algos as well as the proliferation of Algorithmic nomenclature that has been used to name the trading algos. Brokers have come up with catchy names and phrases to make the algos stand out from others rather than come up with a naming convention that gives insight into what the Algorithmic is trying to do.

With some having descriptive names, others aren't as descriptive and make it hard for traders to use the algos. Today we look at one of the most common nomenclatures that classify the algos into three categories: aggressive, working order, and passive.

Aggressive/Hyper-aggressive Algorithmic Strategy

These algos are designed in such a way that they complete an order with a high level of urgency. They are meant to capture as much liquidity as they can at a specific price or higher for better profits. Such Algorithmic strategies use descriptive terms like "grab it" and more.

Working Order Algorithmic Strategies

These are a group of Algorithmic strategies that try to balance between cost and risk and make sure they use the appropriate limits when placing orders. They include VWAP/TWAP, Implementation Shortfall, POV, and more.

Passive Algorithmic Strategies

These Algo strategies include those that try to interact with order flow while leaving a market footprint. They use crossing networks and dark pools to execute their orders.

Types of Algorithmic Strategies

These include:

Single Stock

These types interact with the market after input of settings by the user. The aim is to take advantage of the best market conditions as best as they could. They are independent of each other and the decision that is made based on how the decisions affect each order.

Volume Weighted Average Price (VWAP)

These participate with proportion according to the intraday volume curve. For instance, if 10 percent of the day's volume trades within the specific period, then the Algorithmic will transact 10 percent of the order within the same period.

Time Weighted Average Price (TWAP)

These algos execute their orders depending on the participation rate throughout the whole day. You need to note that most of the algorithms won't participate in the opening and closing auctions because there isn't a mathematical method to determine the number of shares to enter in such auctions.

Volume

Also called volume inline, percentage of volume or participation rate algos, they participate with the market volume at a pre-determined rate such as 10 percent and continue to trade until the entire order is executed. Due to this, the Algorithmic trades more during times of high liquidity and less during times of low liquidity.

Arrival Price

This term has different meanings for different brokers. Generally, it is a strategy that gets determined from optimization, which balances the tradeoff between the cost and risk. The investor takes time to specify a level of trading urgency or risk aversion.

Elements of Algorithmic Trading

Any trading Algorithmic consists of a set of components that you need to know about. This is consistent with the kind of markets that you wish to trade in, then go ahead to develop the logic with which you wish to trade the various markets and then define the parameters through with the trading logic gets triggered. Additionally, the system you choose needs to incorporate the cost of trading as well as the commission.

Today we look at the four elements that make the perfect Algorithmic trading:

Data

Algorithmic trading is a complex strategy that drives business investment decisions through the use of insightful data.

The use of data has made it possible for traders to perform a powerful analysis. The sad thing is that only a few traders have taken advantage of this fact.

Various strategies that are part of the Algorithmic strategy make use of data in real time to make sure they get the real analysis from the data.

Changes in any market are notoriously tough to the source because they can arise from anywhere – the use of data science techniques helps reduce this by allowing the traders to combine data originating from a wide variety of sources then examining historical data to help determine current or upcoming market situations.

Apart from combining the data from different sources. Another huge benefit of using data in algo trading is that of reproducibility. When you use the right data, you get to distill information that would otherwise be impossible for traders, however diligent, to achieve.

Algorithmic trading uses Big data, otherwise termed as large data sets. The data is used to identify trends, patterns, and predict the outcome of a wide variety of events in the market.

Data used in the market can be structured as well as unstructured. Data is usually defined in terms of the three Vs. – Volume, Velocity, and Variety. Volume refers to the amount of data that you collect and store while velocity is the speed at which you send and receive the data. Variety is the different formats of data on the market.

Based on the components of big data, retail traders, and financial organizations can enjoy a great deal of information to help them in their trading decisions. Various analytical tools are used to look at user behavior and to identify the various trends.

Predictive analysis forms a huge part of the use of big data. Data

from various marketing platforms are crunched through the use of advanced techniques of Artificial Intelligence and Machine Learning to predict the behavior.

Data can be supplied intraday, daily or monthly as defined by a particular user. With the growth in the sources of information, the techniques used to gather, analyze, extract, and categorize the information results in large returns, either positive or negative.

Either data input is provided to the system in a bundles form from the brokerage, or it is received from a specialist real-time tick resolution vendor. You have to decide on who supplies the data so that you are up to date on what you receive.

Usually, all the brokerage trading platforms come with a data feed that you can access then feed into spreadsheets easily. Other vendors provide tick historical data for stock definition and clustering.

Purchasing historic tick data is one of the best decisions you can make, but make sure you take time to get a longer lookback (at least three months) so that you achieve long-term patterns.

Trading platform

When using Algorithmic trading, you need to trust your hard-earned money to a specific trading platform to use. The right platform makes sure you enjoy both effective and accurate execution when you place the orders. Faulty platforms, or one that doesn't have the required features, might lead to huge losses.

There are two ways to access the platform – build or buy. Purchasing a ready platform gives you quick and timely access to operations while building your platform takes time though it allows you to customize the platform to your needs.

Ready-made platforms might be costly to purchase and might eat into the profit potential from your trading revenue. On the other hand, building your platform takes time, deep knowledge, and effort, and it might not be fully functional.

The risks involved in trading are high, the reason why you need to be familiar with the features that make the best platform. Let us look at a few of them:

- Availability of data: all trading platforms are meant to act on real-time data from the markets as well as price quotes. Any platform needs to have access to real-time data feeds. The data needs to be built into the system or should allow for integration from other sources.
- Connectivity: the platform should allow for connection to multiple markets. You need to understand that different markets provide different feeds in a wide range of formats. Another option to use would be to go for data vendors that aggregate data from different exchanges and give it to you in a uniform format. The platform you use needs to be able to process the different feeds as required.
- Latency: the platform should promote latency in such a way that there is a time-delay introduced in the shifting of data from one point to the next. The time needs to be in nanoseconds, which is fast enough to give you faster returns for every data that you analyze.
- Customization: the needs of one trader are different from the needs of other traders. To this end, you need to have a platform that allows you to customize the existing parameters. If you use a platform that doesn't give you this functionality, you will be constrained by the fixed functionality. Whether you plan to use the platform for buying or selling, the platform needs to have a high level of configuration and customization.
- Ability to experiment: go for a platform that allows you to write your platform. Some platforms allow you to experiment and try any concept that you develop. Go for a platform that offers to code in a programming language of your choice.
- Backtesting feature: backtesting allows you to test a strategy on historical data. The feature assesses the practicability of past data and certifies it for success. To achieve this, you need to have access to historical data that you can perform the backtest on.
- Integration with a trading interface: the platform you choose needs to have a trading interface in a language that you can understand. It needs to have connectivity to the broker network so that you can place a trade directly to the exchange as well as send trade orders.

- Plug n play feature: the platform needs to have easy plug n play integration for easier use. It should give APIs that can easily integrate into various trading environments. This is ideal for scalability as well as faster integration.

Where should you begin?

Ready-made algo trading platforms offer a trial though it comes with limited functionality. Alternatively, you can get a trial period with full functionality but for a limited time. However, either way, you need to make sure you go through the documentation to make sure you know what you are getting into.

If you plan to build your platform from scratch, you need to have an online source to test and develop your platform. You can try out existing versions or write a completely new one.

Programming

One of the top questions is, “What is the best programming language for creating an Algorithmic trading platform?” The answer is that there isn't any best language for the task; instead, you need to look at the strategy parameters, the development, performance, resiliency, and the cost.

The major component of any Algorithmic trading system needs to be considered, such as the research tools, risk manager, portfolio optimizer, and execution engine. After this, you need to look at the various trading strategies and how they can examine the design of the platform. Here, you need to discuss the trading frequency as well as the trading volume.

Once you select the trading strategy, the next step is to make sure you design the entire system the way you need it to be. You need to consider the hardware, the operating system, and issues that might arise.

Before you decide on the programming language, you also need to ask yourself what the trading system will try to do. Is it going to be transaction or purely execution based? Will it require a portfolio construction module or risk management? Will it require a high-performance backtester?

Before you go in for design and programming, you need to

understand the kind of markets that will be traded, the connectivity to external data sources, volume, and frequency of the strategy.

You also need to consider the research systems, which typically involve automated scripting and interactive development. The latter often takes place within IDEs such as R Studio, Visual Studio, and MatLab. The former involves extensive numerical calculations over data points and parameters. This gives you a guide on the kind of environment to choose.

Popular IDEs include Microsoft Visual C++/C# that gives you extensive debugging utilities, an overview of the entire project and code completion capabilities.

Brokers

The next aspect of any trading system is choosing a broker. You don't need just any broker but the right one to help you achieve your goals. When choosing the broker, you need to look at various aspects that include:

- The speed and efficiency of the trading platform.
- The types and number of segments the broker offers.
- The level of compatibility of the charting software with the platform.
- The type of brokerage available to you.
- Gateway APIs that are available to you.
- The margin and leverage requirements.

As a trader seeking to automate your trading process, it is vital that you execute your strategies the right way using charting platforms. These platforms connect you to a broker via the various APIs that are offered.

To succeed in trading using Algorithms, you need to understand what APIs are available to you and know how the APIs work.

System

As a trader, you know that you will have access and will be working with different platforms and applications, including programming tools, charting platforms, news feeds, and broker terminals. You also interact with huge data sets for backtesting and running trades on the live markets. It is therefore vital that you have the right

computer system that will fulfill your needs.

Remember, automation aims to make sure you fulfill trades faster and smoothly without any emotions involved. Trading with your PC or laptop isn't reliable because of the restriction in performance. With limited capabilities, you will limit your trading capabilities. It is therefore prudent that you use a high-end workstation with multiple monitors so that you don't keep on switching from one screen to another.

You need a machine that has fast processors and high RAM to allow you to multitask easily. You also need ample storage space to store files when necessary. To get the best system, you need to research the requirements or consult someone with sound knowledge on computer hardware systems.

Chapter 5:
How to Become a Pro Algo Trader

Skills of Algorithmic trading

To be a successful Algorithmic trader, you need to possess a set of skills that will make you not only competitive in the market but also give you the kind of profits you desire. Algo trading involves automated buy and sell transactions, which involve financial instruments like stocks, bonds, and futures. It needs you to have an electronically networked connection, buy and sell parties, brokers and a platform to execute the buying and selling as well as other trading tasks such as supervision of market vulnerability and price movements.

To this end, you need to have a set of skills that will make it easy for you to execute these tasks.

Technical Skills

Algorithmic trading needs you to have two types of technical skills – domain knowledge and code development. Domain knowledge is all about knowing the stock trends in the various sectors. On the other hand, programming skills require you to have an effective command of the programming languages.

Numbers, Numbers, and Numbers

Any aspiring Algorithmic trader needs to be good with mathematics as well as quantitative analysis. For instance, if terms such as skewness, conditional probability, and kurtosis don't make any sense to you, then you still have a long way to become an algo trader.

In-depth knowledge of mathematics is essential because you need to perform research, test the results, and identify trade strategies. Understanding mathematics is vital because it helps you come up with foolproof strategies. With trade executions becoming faster and more efficient, you need to make sure that you understand all there is about numbers. Remember that a small mistake in the underlying code can lead to huge trading losses.

Core Skills

You also need to have at least three core technical skills: programming, risk management, and statistics. These are just the base skills that you need. Aside from the core skills, you also need big data analysis, numerical optimization, and machine learning. These might not be as significant as the base skills, but they are still powerful enough to make your trading experience smoother.

Economic and Financial Knowledge

Knowing behavioral finance, market microstructure, and macroeconomics helps you make vital decisions and understand the market much better. Though they don't form a part of the minimum requirements, they help you make trading decisions that subsequently influence the outcome of your trades.

An Overview of the Core Technical Skills

Let us look at how the core technical skills help you achieve your Algorithmic trading goals.

Programming

You need to be familiar with analysis, data mining, research, and the use of automated trading systems.

Knowing about programming is essential as it allows you to perform useful research. Try to learn one or two C-based languages such as C++ or Java. Consequently, you need to concentrate more on data structures and Algorithms that give you a foundation in trading.

To enjoy better research, it is prudent that you become familiar with a higher-level programming language such as Python, R, or MATLAB. These languages are easy to learn as long as you get the right platform. One of the most common languages is Python. It is vital to learn the language because it helps you acquire data, process it, and manage it from various sources. It is also a great tool for research since it makes it easy for you to run analytics on data due to the various libraries that are available for the task.

Similarly, you can opt for R for data analytics and research because it is backed by a huge repository of libraries and functions. R was made with statistical analysis in mind, and it is a natural fit for the kind of work that is needed by the Algorithmic trader.

If you have some knowledge of engineering, then MATLAB is your best option.

You can go for any of these high-level languages, but it isn't essential to learn all of them because most of them come with crossover capabilities. With time, you get to know what language suits your needs.

Familiarity with spreadsheets and other concepts such as data structuring and big data is a bonus.

Speed, Accuracy, and Flexibility

These are skills that you need to have so that you can run your tasks fast and easily. To develop these skills, you need to undertake modeling tasks using a simulation environment. The simulation environment gives you capabilities that you can use to test the various tasks that you plan to execute.

You can have your simulation environment or use simulations that have been developed by other traders. Simulation helps you build and fine-tune these skills to develop trading strategies as well as perform actual research.

Statistics Knowledge

Having hands-on knowledge in statistics is a necessity for any Algorithmic trader that wants to be successful. Statistics form the basis of any task you deal with as a trader, right from performance measurement to risk management and development of strategies to decision making.

Statistics form the backbone of most of your Algorithmic trading ideas. Some of the statistical functions that you will run include correlations, statistical tests, and regression analysis.

For instance, you use statistical analysis to determine whether the market you are entering at any particular time is ideal for trading or not. You can also use regression analysis to test the ideas that pertain to different factors that influence the market.

Risk Management

This is a vital function for every Algorithmic trader. While placing

orders on any market, you encounter various risk factors such as counterparty risk, infrastructure risk, and other risks that occur at portfolio and trade levels. The risk factors you encounter come in various forms, for instance, the risk of your servers going down due to various reasons, loss of your trading account when a broker goes bankrupt or the inability of the counter-party to complete a transaction.

To mitigate the risks, you need to understand the fundamental principles of risk management. This is a complex area that requires you to understand the possibilities you have to mitigate the risks. To do this, make sure you learn Mean-Variance Optimization and Kelly Allocation.

Testing of Ideas

As a trader, one of the plans you need to have is progression. You need to move from one stage to another. To this end, you need to develop the habit of testing your ideas rather than having to rely on ideas that have been tested by other traders. To test your ideas, you need to perform high quality, objective research.

Research allows you to decide what to do to achieve your goals. You also need to come up with practical applications. Research allows you to understand the current trends in the trading market and how to implement them in your trading patterns.

By implementing the ideas that you have learned about, you get to sharpen your technical skills and develop a mindset and creativity that will make you succeed at Algorithmic trading.

To learn the different skills, it is vital that you assign sub-tasks to each one so that you master it much better. For instance, when learning Python programming, it is vital that you divide it into the various subtasks that include data types, loops, syntax familiarity, variables, functions, debugging, and object-oriented programming. You can further subdivide the subtasks into smaller tasks for easier learning.

Understand Common Trading Concepts

You need to discover and design your unique trading strategies as well as models from scratch. You also need to have the skills to

customize established models. You need to know popular trading strategies.

Computer Usage

As an Algorithmic trader, you will need to implement your trades using real-time data containing commodity prices and quotes. You, therefore, need to be familiar with associated systems, especially terminals that provide content and data feeds. You also need to be comfortable with analysis and charting software and be able to use broker-trading platforms to identify and place orders.

Soft Skills

As a trader, you also need to have soft skills to succeed in the market.

First, you need to have the right attitude. Remember, not everyone can behave like a trader. Successful traders are on the lookout for innovative ideas to handle trades, can adapt to the changing markets, and thrive under stress due to long working hours.

Secondly, you need to be able to accept failure. Some trading ideas might seem foolproof, but when you put them to the test, you realize that they aren't what you were looking for. Many aspiring traders fail solely because they believe fully in an idea and try to force it to work even when the market conditions aren't favorable. They find it hard to accept failure and aren't willing to let go of the concept they have adopted. On the contrary, successful algo traders know when an idea isn't working and let it go to try another strategy.

Third, you need to have an innovative mindset. The trading world keeps on changing day in day out, which means that a concept won't make money for you over a long time. With systems competing against each other, it is upon you to decide what will work for you and what won't work for you. Remember that the decisions you make regarding the right strategy will make you survive or fail. This is why you need to make sure that you look for innovative ideas that help you seize opportunities that might soon vanish.

Financial Marketing Acumen

Before you dive right into algo trading, you need to have a clear understanding of the financial markets. All the programming and statistical knowledge become useless if you don't understand what financial markets are all about. You need to understand the various technologies that are in use in the market to understand the reasons why price movement happens.

Problem-solving Capabilities

You need to have solutions to challenges that come up when you trade. It is not a guarantee that every trade you place will give you the returns that you desire – at times, you fail. Problem-solving capabilities help you to come up with the perfect trade ideas, as well as model the ideas to suit your particular objective. The right problem-solving skills give you the ability to come up with solutions.

Data Management

Having access to high-quality data is vital for any trader. While markets and vendors provide different kinds of data for different prices, it is hard to access historic intraday data. It is therefore vital that you understand data patterns across the various markets globally.

Once you have the data, the next step is to clean it and structuring it in such a way that it is uniform with the database. After this, you need o use the data to identify patterns, come up with, and optimize various patterns.

Understand System Architecture

Most of the trading activities will happen on a trading platform. Therefore, it is vital that you understand how a trading system works and how to use it. You need to know the various components of the system such as the adaptors, event processing engine, and more.

Compliance and Regulations

Every region has its own set of rules and regulations that you need to adhere to trade in the market. The rules relate to co-location, short selling, system approvals, and more than you need to know

about.

For instance, some exchanges require you to perform approval at the overall system level, while others require approval to be performed at the strategy level.

Simple Trading Strategies

Once you have your mathematics and programming skills in check, the next step is to go for the real work. Placing orders is all about using a specific strategy that works for you, learn about the various strategies and the scenarios that they apply to know which strategy to choose for the type of trade.

The Mindset of the Pro Algorithmic Trader

Being a trader isn't all about formulating strategies and performing an extensive analysis of data, but it is all about coming up with a winning mindset. Various aspects separate the winning trader from one that constantly loses:

- Winning traders don't formulate better strategies for trading.
- They aren't any smarter than other traders.
- They don't undertake better market analysis.

The only thing that separates the winning trader from losing one is the psychological mindset that they adopt.

Most of the traders make the mistake of believing that all they have to do is to get a great trading strategy. What they think is that all they have to do is to get the strategy, log into the market each day and the market will start loading money into their account.

Unfortunately, this doesn't happen the way they thought. For your information, some so many people make use of intelligent, well-designed systems but lose more money than they gain at the end of the day.

Those traders that end up with money in their accounts are those that have developed the perfect mindset that allows them to win consistently. They follow certain beliefs, psychological characteristics, and attitudes that are ideal for conquering the trading world.

The Attitude

Many traders, especially the ones that end up losing, believe that the market is rigged against them. Such erroneous beliefs affect the ability to trade. If you look at the market and you think that it is operating against you, it is time you realized that there are a lot of people that are trading successfully on the same market as well.

Every market is neutral, and this is why you see more people signing up to it and using it to run their trades, day in and day out.

One of the best characteristics that many winning traders have is that of self-confidence. They believe that they can win the trades that they take part in.

Many losing traders, on the other hand, have self-doubt that they are cursed and this goes ahead to be a fulfilling prophesy. If you doubt your abilities, you often hesitate to initiate a trade that would have been profitable at the end. They also tend to cut the profits short, due to their beliefs that the market will soon turn against them.

Traders who win know that the market might at times go against their expectations, but they don't give up that easy. They undertake market analysis, but they know that even the best analysis might not match up with the price movements. However, they know when it is the right time to place a trade, and they go ahead to do it when the opportunity arises.

Characteristics of Winning Traders

Winning traders have characteristics that they possess:

• *They Take Risks*

Winning traders are comfortable with taking risks. People that are averse to risk-taking cannot be the best traders at all. Remember that losing is part of the trading game. Traders that are out to win can accept the uncertainty that comes with trading. They understand that trading is not like putting money in a savings account where you are guaranteed returns.

• *They Adjust To Changes Quickly*

Winning traders can adjust to changes fast enough. Many losing traders aren't able to let go of trades that once worked for them, and they go ahead to fall in love with their analysis of the market. For the winning traders, if the analysis shows that they need to change their stance on future price movements, they go ahead and do so fast.

- *They Are Disciplined*

These traders look at the market and any other aspect objectively, and regardless of how the market treats them, they don't change their stance or their goals. They operate with strict money management rules that allow them to calculate the potential risk and reward before they enter any trade.

- *They Are Not Emotional In Their Trades*

As a trader, you know too well that the trade can go any way – up or down. The direction of the trade determines whether you win or lose. Winning traders don't have the time to get excessively excited when they win trades or despair when they lose a trade. Instead, they control emotions instead of letting the events of trade affect them.

Apart from the mentality of the trader, they also have a few habits that make them winners all the time. These include:

- They regularly assess their performance and review it trade after trade or day after day. They know that trading is a skill that has to be mastered and built by embracing ideas that are working and casting aside the ideas that aren't working at all.
- They are flexible. These traders don't invest their egos in the trades they place. They view the market objectively and will cast aside any ideas that won't work for them.
- They take up risk when they see a genuine profit opportunity that is based on the trading strategy and market analysis. However, you will see that they don't risk their money recklessly; instead, they know the percentage of risk and the percentage of reward, which in turn drives their decisions.

They Know That the Market Cannot Be Predicted

Winning traders understand that the market changes day in day out, and it is unpredictable. They also know that there isn't any surefire method that can predict price movements perfectly. Due to this fact, they watch for signs that will show mistaken price predictions and then adjust their positions.

In contrast, a losing trader once he places a trade tends to look for actions in the market that confirm that they are right, and they minimize any market action that seems to go against their analysis. They most often end up losing trades and taking a lot of losses.

The Discipline of a Trader

Trading environments come without any boundaries, and the market is a free environment that you can use to buy, sell, enter, and exit whenever you feel like. You don't have to follow any rules of trade at any given price and time. Due to this fat, you have the freedom to make any decision you want whenever you feel like. It is upon you to decide the way to go – recklessness or discipline.

The best way to go about it is to make sure you come up with a set of rules to govern the trading and to be disciplined.

Self-discipline is critical to winning trades. Unfortunately, this is a hard thing for most people to understand and follow. Many people work well when there are rules from an external source rather than from within themselves. Many believe that since they made the rule, they have the freedom to break them. While it is technically true and possible, it is not a winning attitude.

Common Mistakes That Algorithmic Traders Do

One of the major issues to address as an algo trader is the mistakes that you make as a trader. These mistakes usually occur during the trading environment or the testing phase. Let us look at a few of them.

Failure to Understand the Differences between Long and Short Positions

Many times, the trader fails to differentiate between bullish and bearish markets, which in turn confuses him when it comes to taking up positions for sale (Short) and buy (Long).

The Need to Rely Solely On Technical Analysis Indicators

As you perform your research, you will come across a lot of literature that talks about indicators, and it is accompanied by numerous examples of their use in trading. Well, indicators can be used in trade algorithms, but the signals need to be checked out and confirmed with applications that can compute the outcome.

Failure to Match the Strategy to the Right Product or Group of Products

One of the top issues that arise when a trader loses is that they fail to choose the right product mix when it comes to trading. You need to check if your trading strategy is suited to a different product to the one you are trading at the moment. Doing this allows you to get more from your strategy.

Overtrading

This can mean many things. It can be too much leverage or simply risking too much on a single trade. It could also mean taking up too many trades that end up harming your performance.

When this happens, look for a way to reduce the number of trades. Be selective when picking a trade or go for higher timeframes so that instead of going for 1-minute trades, opt for 30 minutes or more.

System Interference

The intention of using the algo trading system is to let it do the work for you. You shouldn't think about it and what it is to do, don't tweak it when the trade is running or think of how to ramp it up. Just leave the system to run the way you programmed it to do.

Over-optimization

Many traders want to squeeze more money from the system in the shortest time possible. This concept can happen even when you don't know it at all, but you need to have the capacity to realize when the system is in overoptimization mode.

Going for Low Profits per Trade

Try to focus your strategies on a higher profit margin per trade. Anything less than $50 is too low, and you will find yourself struggling to cover the commissions and other trading costs.

Going For Strategies That Have No Exit

You need to be careful about those strategies that don't give you a way out, especially those that don't have a money management system in place.

Failure to Anticipate the Unexpected

In algo trading, anything is bound to happen. The internet connection might go down, or the servers might crash, and you might lose any data that you were running. While unlikely, you might find yourself in these and many other situations that you never expected in the first place. This is why it is necessary to be ready for anything!

To mitigate this, you need to invest only what you are willing to lose and make sure you only take on a risk that the account can bear.

Not Including Commission and Slippage in the Backtest

Many traders fail to include transaction costs in their estimates such that when they get the returns, they realize that they are making losses because all the profit is gobbled up by the transaction costs.

Overconfidence

One huge mistake that you need to avoid in trading is being overconfident. A few novice traders might hit it lucky the first time, and then they become too overconfident to the point that they take on too much risk. Remember that being humble and disciplined is the key to trading success.

Treating Your Trading Like a Hobby

Imagine telling people how you are making money in algo trading yet you don't have a record of the inventory, sales and more – people would think you are lying!

For the same reason, you cannot trade if you don't keep the right records. Using records allows you to know what works and what doesn't work. You need to note down various aspects of the trade, including how much you have put in, the positions to hold, etc.

Chapter 6:
Strategies of Algorithmic Trading

There are various strategies of Algorithmic trading that you can opt for to make a profit. Let us look at each one in detail.

Arbitrage

This is the first type of trading that uses price differentials to give you risk-free profit. No trading strategy is free of risks, but when used properly, Arbitrage trading comes pretty close to being risk-free.

Arbitrage trading occurs when the asset in question deviates from a fair value that has been allocated to it. Typically, arbitrage trading means you purchase a security and sell it off the same security to enjoy the benefits of short-term market inefficiencies.

When arbitrage is correctly structured, the trade needs to be neutral in the sense that it eliminates the risk. The risk in this sense is a sharp move in the market that can result in the trade becoming disrupted.

The biggest risk in arbitrage trading is that the market isn't always consistent, and it is possible that the trades can go either way instead of moving in direct correlation. An example is when a large investor drives the stock disproportionately lower by selling off the entire stake that they hold in a company. This causes the price to fall temporarily.

Merger Arbitrage

This form of arbitrage trading is riskier to the trader. It involves purchasing shares of a company after an impending buyout then capitalizing on the difference between the buying price and the buyout price. This is possible because a company that is being bought out usually trades at a lower price to the buyout price.

Example

Say, company X announces a buyout of Company Y for $20 per share; Company Y's share price might trade initially up to $18.90. In such a situation, shareholders in company X might be unwilling to sit and wait for several months for the deal to finalize to get an

extra $1.10 if profit. They might decide to sell off their shares and get some profit now.

As an arbitrage trader, you see the $1.10 profit as a goldmine, especially when there is very little risk involved in the whole deal. The risks might include the merger being called off. You can make a large profit by buying the shares at $18.90 and waiting for the deal to close then sell off the shares at a profit.

Financial Arbitrage

This refers to foreign exchange trading. It means going long and short simultaneously when exchanging two types of currencies. When you check out the prices of the currencies on the different exchanges, you realize that they differ. This means that you can buy the currency on one exchange and sell it on another to make a profit.

Example

Broker A offers the USD/EUR pair at 5/3 dollars per euro and another broker B offers the same pair at a rate of 5/4 dollars per euro, then you can convert 10 euro into USD with the former broker and then you can convert the USD back to EUR with broker B. this results in profit.

Statistical Arbitrage (StatArb)

The description of this form of arbitrage is way beyond the scope of the book, but you need to know that it is slightly similar to pairs trading but on a more expensive scale.

Those who trade using this form of arbitrage find thousands of stocks that are expected to move in similar ways according to statistical references but in opposite directions. To achieve statistical computations, the trader uses complex software for the task. They capitalize on the price movements by going for stocks that are in long and short positions, though this depends on the specific kind of commodity.

Example

If a trader thinks that Facebook stocks are overvalued, and Amazon stocks are undervalued, he can go for a long position on Facebook and a short one on Amazon, a concept known as pairs trading.

Dividend Arbitrage

This involves purchasing a certain amount of stock as well as the put options in the same amount of stock. This is ideally done before the expiry of the dividend date. When you collect the dividends, you exercise the put option.

However, you need to make use of dense mathematical formulas and a lot of expertise to make this work for you.

Example

Imagine that stock AB is currently trading at $100 per share and pays out dividends at $3 per share within a week. You can go ahead, invest in the shares, and enjoy a payout of the dividends in a week's time.

Retail arbitrage

Just the way you use arbitrage in financial markets, you can do the same with your usual supermarket for normal retail products. For instance, a look at eBay shows you a range of products that are sold at a low price in China but a higher price on a different platform.

Example

Buy an item on Wal-Mart and then sell them via Amazon or eBay at a profit.

Convertible Arbitrage

This refers to a process of buying convertible securities than selling the underlying stock in the security.

Example

Goodyear is selling its tires to clear stock at $60. These tires are priced at $90 on other markets. You can buy the tires and then enjoy the profits that come with it

Negative Arbitrage

Usually, this opportunity is lost because the interest rate that the borrower ends up paying on debt is higher than the associated interest rate at which the funds are invested.

Example

Let us assume that a council wants to build a new road and it issues bonds worth $100,000,000 at 6% municipal bonds to pay for the construction costs. Due to the changes in the interest rates, the council ends up earning only 3% in the accounts while paying the bondholders 6%, losing 3% to negative arbitrage.

Arbitrage opportunities usually occur in various scenarios:

- Stocks with multiple share classes.
- Stocks that feature on multiple exchanges. For instance, we might have a stock that is trading primarily in Australia but is listed in Canada as well.
- Stocks that are linked to specific future markets.

For the condition to take place there must be at least two equivalent securities but that have differing prices. This is the only situation that will give you profit due to the imbalance in the prices in differing markets.

Traders that engage in this form of trading are called arbitrageurs. The concept bases its operation on the market efficiency theory, whereby it states that for markets to be efficient, then there must be no arbitrage opportunities – all the equivalent securities ought to converge to the same price. This convergence of the prices is the true measure of market efficiency.

Perfect Example of Arbitrage Trading

When Warren Buffet was six years old, he saw that he could purchase a 6-pack of coca cola at 25 cents and then sell a bottle from the pack 5 cents, enjoying a profit of 5 cents in each pack. He saw that he could profit from the difference in the price pack compared to what the people were able to pay for each bottle.

Conditions Necessary for Arbitrage to Occur

Arbitrage can only occur when the following conditions are satisfied:

- Presence of asset price imbalance. This can be in various forms such as the same asset being traded in different markets, assets that have similar cash flow getting traded

at different prices and if an asset with a known future price that is being traded at a price that is lower than the future cash price.

- Simultaneous execution of trades. Here, the buying or selling of equivalent assets needs to be executed simultaneously so that it captures the price differences. If the trades don't run simultaneously, then the trade faces significant risks.

Arbitrage in Retail

While retail traders can take advantage of the financial instruments that occur across different brokers in different prices, it is hard to achieve. The huge competition in retail makes sure that the prices usually remain the same, with a few exceptions; this means that many brokers won't make a lot of profit on trades, which in turn restricts the trades. If you take the transaction costs into effect, you find that such opportunities in the industry are almost non-existent.

Another Example

Let us say that a stock company A trades $20 on the London Stock Exchange, and a trader finds that the same stock is trading at $20.80 on the New York Stock Exchange, then trader can simply buy the stock on the LSE and sell it at a profit on the NYSE, making $0.80 on each stock.

However, you need to understand that you might not be the only investor that has identified this opportunity, and many traders will be after the same. Therefore, you need to use Algorithmic trading applications that identify the opportunity and grab it before anyone else can do so.

Remember that once the demand rises for the stock, then the lower priced stock will rise in LSE and the increased supply on the NYSE will push the higher-priced stock lower.

Currencies offer one of the most popular securities for arbitrage trading. Unlike asset trading, currencies don't have to be traded on centralized exchanges at all but can be handled on over the counter markets globally.

Advantages of Arbitrage Trading

- The biggest advantage of arbitrage trading is that it eliminates the risk. With the right research and identifying markets that sell the stock at a higher price, you are sure of making a profit from the trade.
- The popularity of arbitrage trading makes it possible for prices of securities across the market to stabilize. It helps keep the prices of securities across the markets at a stable price; therefore, end the price variances across the different markets.
- With this trading strategy, the financial markets become more efficient because it builds the confidence the investors have in the market.
- Disadvantages of Arbitrage Trading
- Many traders ignore the aspect of transaction cost and only focus on the price aspect of the security. Transactions such as taxes and other hidden costs might give the wrong profit estimation, which in turn leads to losses as opposed to profits.
- You might not be able to enjoy many arbitrage opportunities as you might wish. Additionally, even if the opportunities present themselves, you need to have the latest trading software to identify the opportunities quickly and make profits. The expertise needed to take advantage of these opportunities aren't common to many people.
- You need a huge capital outlay to take advantage of arbitrage. The truth is most arbitrage opportunities give you profits in cents, which means you need to have more money to invest to enjoy the returns.

Momentum Trading

Momentum trading, just as the name implies, attempts to take advantage of the trends in securities - both upward and downward trends in the price.

Traders that use this style believe that the trend will continue in the same direction for a certain period due to the momentum that has been generated behind the security. Let us look at the different types of momentum that you need to look at to enjoy this trading.

Price Momentum

One of the best models to use in this type of trading is price momentum. If you plan to use this as your basis on making decisions, you need to look at stocks that have been going up each day, week after week, or maybe for several months. To this end, you need to have a lot of evidence that shows that the markets that are at a new high will maintain the highs for longer.

However, this type of momentum is more volatile than other strategies. This form of trading takes advantage of the volatility level of the market. Therefore, if you don't time the buys and sells the right way, you might end up with losses. You need to use some risk management techniques (such as stop-loss) to minimize losses.

You also need to have the right settings for the trading platform so that you can identify stocks that are trading at a high price over a long period.

Example

In the mid-2008, the oil and energy sector experienced a steady increase in the price of related securities. It became ranked among the top sectors that used the metrics based on 12 week and 24-week estimates. Even when the market was failing, it remained profitable for most of the traders due to the large gains.

As a trader, you need to be vigilant to spot trends early on. You might, therefore, want to include a short-term price change component in your calculation, for instance, a 2-week or a 4-week price measure.

To success as a momentum trader, you need to identify the right sectors fast and accurately. You can do this using the various manual screeners that are available.

How to Identify the Right Sectors for Momentum Trading

- Identify the stocks that you wish to trade in.
- Determine the number of stocks that are trading closer to their yearly highs.
- Sort the stocks depending on their performance from high to low.
- Come up with an entry strategy –choose whether you want to enter the market when the stock is showing the best

strength or wait to buy on the weakness of the stock.
- Have an exit strategy. Know when to go into the trade and at what point you wish to get into the trade.

Tools to Use for Advanced Momentum Trading

You can use a variety of technical tools to achieve profits with the momentum trading approach. The tools include chart readers, moving averages, relative strength, and oscillators. These tools come with many of the trading platforms that you will join. However, take time to identify and choose the best tools that complement each other and give you the best results.

Generally, the momentum of any stock is strongest at the earliest stage of the trend and weakest just when the trend is near to reversal. We can use the example of a ball that accelerates fast when it leaves your hand and slows down just before the point of its final peak before it returns to the ground.

Additionally, to ride the wave of any momentum, you need to fine-tune the technical indicators that identify a particular stock that is worth investing in. Know when to exit, which usually is indicated by fading momentum.

Let us look at the technical analysis tools in momentum trading

The primary point of reference for most investors starts with technical analysis. This is all about trying to determine how strong each asset is in terms of prices. For any trader, knowledge of the key indicators forms a crucial part of the trading strategy.

1. Trend lines

This is a tool that is ideal for monitoring price movements. The trend line joins two successive points on a price chart. If the line slopes upwards, then the indication is that there is a positive trend, the perfect signal for the investor to buy shares. If the line is sloping downwards, the trend is negative and selling short is the best position to adapt.

2. Moving Average

The moving average helps traders to identify a prevailing trend while eliminating the irrelevant signals that come from insignificant

price changes. When the price remains steady or moves above the moving average, then this indicates a positive trend. A negative trend usually occurs when the position is below the moving average.

3. Stochastic Oscillator

When you wish to compare the closing price to an asset and the prices over a period, then this is the perfect indicator. When the closing price occurs near a high, then the trend is positive, and if the closing price is much lower, then the trend is negative.

The values for this indicator range from 0 -100. Numbers between 51 to 100 indicate a positive trend, while numbers below 50 indicate a negative trend.

4. Average Directional Index

Abbreviated as ADX, this momentum indicator is the most popular because it is considered less likely to produce a false signal than the Stochastic Oscillator. This index is ideal for determining the presence of a trend and how strong it is.

The values in the index range from zero to 100. An index below 25 shows a directionless range, which means the market has no clear trend. Anything above 25 indicates the presence of a trend, and higher readings show a stronger trend. A value of 50 on the index is stronger than a value of 40 on the same index.

Things You Need to Focus on In Momentum Trading

Since momentum trading takes advantage of the short-term price action of a commodity, you need to make sure you focus on a few things that will determine the direction of the decision you take. Here are some things you need to look out for:

a. The stock Volume

This is the number of shares that get traded on the market. Since the aim of momentum trading is to get in and out of the position on the same day, it is vital that there are enough traders on the market for the commodity in the market. It is vital that you focus more on a stock that has high volume, which will allow you to get into a trade and get out faster. Additionally, stocks with high trade

volume have higher liquidity, which means it can be traded quickly.

b. The Time Frame

Here, we look at the period that a stock moves. Typically, momentum trading requires short-term moves as opposed to the long-term moves. You don't care about what will happen a month or a year down the line. This is the main reason why momentum traders don't have the time to look at the reputation of the company because a terrible company can experience amazing price changes in such a short time and a great company might remain undervalued for years.

c. Volatility and Range

As a trader focusing on momentum trading, there is nothing that won't excite you like a stock that is volatile on the market. You aim to make sure you play significant moves on the market. A stock that is stuck at the same price for several hours gives you a little trading opportunity.

d. Technical analysis

While investors put a lot of care on the state of the underlying company, momentum traders, on the other hand, only care about the stock in question. All you need to look at is the price action because, in the world of momentum trading, the stock is the only product.

e. Catalysts

These are triggers that make the stock to break down or break out. You need to focus more not on the implications of the trigger, but the reaction the market has to the trigger. For instance, then there is a security issue in the country, the stock prices for many related companies skyrocket. The price movement might not be rational, but it did create many opportunities for traders. Understanding how the catalyst affects the market is the best way to determine the price movement of the stock.

f. The Risk vs. Reward

Many people take trading to be a form of gambling, and if you do them properly, you can get the same benefits. What separates the

two is that the trader performs a lot of risk analysis to find the best way to move.

In everything you do, there is an associated risk or reward. With this said, we need to find ways to mitigate the risks while we amplify the rewards. In momentum trading, we look for commodities that have a favorable risk: reward ratio.

For instance, if you enter a trade without the right preparation, you have a 50/50 chance of making a profit, which is gambling. However, if you analyze the patterns and study technical analysis, you will find favorable setups that give you a lower risk.

g. Strength of the Sector

Certain industries run at different times. Some run when new laws are passed while others run when there are headlines about the industry. You need to understand these trends because they help you understand the different movements in the sectors. It also gives you a better opportunity to find stocks to trade in the sector.

h. Stock Trends

It is vital that you focus on the trends of specific stocks. When you get a trend that is uptrending the whole day, you need to make the right decision so that you don't increase the risk.

i. Strength of the Market

You need to pay a lot of attention to the strength/weakness of the markets to better understand the momentum in these markets. You can do this by looking at the various indices on major vendors such as NASDAQ.

j. Trading Setups

Many traders have been found to neglect this factor when trading. Before you enter any position in a stock, you need to have a reason. You need to know why you are entering that stock at that particular price. The main reason shouldn't be because you thought the price would go up later, as this wouldn't make the perfect reason. You need a reason related to the risk: reward ratio or the chances of the stock breaking out.

The Risks of Momentum Trading

- There is no definite guarantee that the pressures of buying will push the price of the commodity higher.
- If many investors are already holding long positions in the stock, it is possible that existing positions will overpower new traders that come to the market, eventually forcing the prices down and resulting in losses.
- It is not a guarantee that the trend will continue. This is because something might not happen just because it happened yesterday, or the week before.
- If you don't know the indicators, you might miss the start of a trend. This means you miss out on the early profits as well.

Trend Following

Trend following aims to isolate trends and extract profits from them. There are a few ways you can do this, but remember that no single indicator can give you the profits you deserve, because trading involves a host of many factors such as trading psychology, risk management, and others.

The basic tenet of trend following is that you ride the trend that exists at the moment – buy when the price is on an upward trend, and sell when the price is on a downward trend. You don't aim to forecast or predict what will happen; all you need is to keep an eye on different markets looking for emerging trends.

Why does Trend Following work? The reason is very simple – trading is run by emotions – greed and fear. This trading strategy has been profitable over the past 200 years due to various reasons.

Principles to Successful Trend Following

Behind the Trend Following methodology are five principles that will give you the success you need.

1. Buy High, Sell Low

You need to find securities that you can buy at a low price and sell them at a higher price to make a profit. The price difference is what constitutes profit. The prices for commodities on different

exchanges vary, and this should be your mainstay. For instance, when trading stocks, always aim to buy at a low price and dispose them off when the price is high enough to give you returns.

2. Make Sure You Know Your Prices

You want to be on the right track all the time. It is always good to know you called the right price at the right time and made the right purchase.

However, there is a downside to this – when you begin making predictions, you tend to cloud your judgment, and you lose the objectivity that you went out to achieve. This can lead to refusal to take losses due to the need always to be right, averaging losses because you cannot go any cheaper now and revenge trading because you want to make back the money that you have lost.

What you need to do, as a trend follower is to make sure you follow the price and act accordingly. When you realize that the price is becoming lower and lower, then the chances are that there is an uptrend in the horizon and you need to go long. If you notice the price forming lower lows, then the chances are that it is on a downward trend and you need to be looking to short it.

3. Learn How to Manage Risks

If you have a system that only gives you minimum profits however long you trade, then you need to know how much to put down so that you make profits. You need to make sure you come up with a winning strategy with proper risk management so that you recover from any losses that you encounter. To do this, you need to understand the percentage loss in the capital as well as the percentage of profits you need to gain to recover the loss.

For instance, if you lose 50 percent of the capital, it is prudent that you make back 100 percent of the capital, especially when you have a winning ratio of less than 50 percent.

4. Trade All Markets to Increase Odds

When you decide to run Trends, you are looking at a way to get more money on upward and downward trends. As a trend follower, you can trade anything ranging from currencies, metals, agriculture, energy, bonds, and indices.

Trend Following Indicators

To enjoy what trend following offers, you need to keep an eye on the market for emerging trends. These trends are visible using trend indicators. However, no single indicator can give you the perfect way to buy or sell a stock. However, a few are used commonly to give the perfect perspective and allow you to make decisions.

1. Moving Averages

This is a widely used indicator that can be used to arrive at a decision that isn't based on price fluctuations. The indicator makes use of a set of historical data that can be used to observe the price fluctuations for a given period. This data also depicts the general direction that the trend will take.

Using moving averages, you can decide whether to take a long or short position for any commodity. If the stock shows a downward trend, then you can decide to sell any stock that you are holding. On the contrary, if the stock shows an upward trend, then you can buy more stock because of the expectation that the stock will rise higher.

Before you plot the moving average, you need to define the period and then choose the right stock to analyze.

2. Bollinger Bands

The indicators that are plotted on a single line show the price fluctuations of a particular stock. They have three lines: the upper, middle, and lower Bollinger band. The upper and lower Bollinger bands form two standard deviations from the mean average. They are used to determine the volatility of different price fluctuations.

Once you plot the bands, the next step is to use them to determine market volatility. When the market becomes more volatile, the distance between these two signals increases with the reverse being true for low volatile situations. When the volatility is high, you need to quit the trade.

3. Moving Average Convergence Divergence

Abbreviated ad MACD, this is a comparative analysis that looks at two moving averages for different datasets. Using the resulting

bandwidth of the series, you can assess the price fluctuations for two datasets of time.

Comparing the moving averages for the data sets is performed based on convergence, dramatic rise, and divergence.

4. On Balance Volume

This is an indicator that measures the volume flow to determine the direction of the trend. The volume and rise in price are usually directly proportional. When the OBV rises, there is a high indication that the price also rises, and the vice versa is true.

5. Relative Strength Index

Abbreviated simply as RSI, you calculate the indicator using the following formula:

$$RSI = 100 - 100/(1 + RS)$$

RS in this sense means the average gain of up periods in a specified time frame. This indicator shows the speed and change in price fluctuations. It provides an idea of how security is performing in the stock market. It gives you a value between 0 and 100 depending on the strength of the stock in the market.

Types of Trend Followers

Two types of traders use this system to make their profits:

Systematic Trend Followers

These use quantitative indicators to get in and out of a trade. Some of the common indicators used are MACt and moving averages. For example, a systematic trader will buy when the market goes beyond the 50 daily moving averages because he believes that the market is in an uptrend so long as it is beyond the 50-point mark. When the market falls below the 50-mark, the systematic trend follower decides to sell the security because they are stuck in a market that is in a downtrend.

Discretionary Trend Followers

These types of traders use the breakout and breakdown pattern to determine the decision. When the market breaks out from a

resistance pattern, the trader buys and decides to sell when they think the market has broken down from a pattern.

Benefits of Trend Following

You Get To Keep Track Of All Movements

With the strategy, you will be able to take advantage of both small and big moves, making profits in the process. Whenever the market moves from down to up, the indicator will give you the signal to buy. If the movement is big, you stand to make huge returns on your investment.

Huge Profit Margins

The profit potential for this strategy, especially when you use the long-term trends, is much bigger. The advantage is that even when the probability of profits is less than 50 percent, you still stand to make profits on your investment. This is only possible if you increase the size of the winning trade as compared to the amount of losing trades. When done right, placing a single trade might be all that you need to generate profits to take you the whole year.

Save on Costs

Another benefit of choosing this strategy is that you can save on costs over a short time and by running more trades. Running trades over the long term reduces transaction costs as well.

Ability to Cut Losses

When you use long-term trends, you can use the prove concept of cutting costs while increasing your profits. This is possible when you stick to the trend for months or years.

The Disadvantages of Trend Following

Just like there are advantages to the use of this trading strategy, we also have the demerits of using the strategy.

More Losers than Winners

You will find that when using the trading method, you get more losing trades compared to winning ones. The big reason is that markets only trend 20 percent of the time.

Additionally, losses occur when you try to catch the beginning of a profitable trend, a very difficult practice. Additionally, since the market is chaotic most of the time, timing the end of this cycle can result in false signals before you make use of the opportunities.

Boredom

Since the market trends, only about 20 percent of the time, this can lead to boredom because as a trader, your main aim is to trade! As a trader, you wish to be involved in trading and make money. Sitting around with a low probability cannot be any fun.

This especially true for those traders who sit in front of computer screens for hours on end. The hours can go on without any proper signal, making it tough for you to decide at all.

Sitting on the computer all day can lead to distractions, and you might find yourself checking out emails or playing a video game, and when you check back on your screen, you find that you missed a great trade.

Factor Driven Trading

This is a trading system that is backed by academic research and top players in the markets. The system draws from the experiences that professional investors have gone through. The system is simple, yet it gives you an approach that reduces your investment risks and gives you the best returns.

Like any other research, the finance market has undergone rigorous testing with a lot of data. The studies have stood against stringent peer review processes with the findings remaining consistent whenever other researchers go through the tests.

These facts and metrics can be taken to be proven beyond reasonable doubts and form the primary drivers for investors to use to get returns.

There are two types of factors that are used to drive decisions: style and macroeconomic factors. Macroeconomic factors look at broad risks within the various asset clauses while the style factors focus on explaining the risks that occur within the asset classes.

Components of Factor Investing

Various components of factor investing include:

Value

This tries to capture how much returns you get from the stocks that have low prices relative to their original value. This is usually tracked by the dividends, price to earnings, price to value, and free cash flow.

Size

Size refers to the market capitalization of the stock. A look at historical figures tells you that small-cap stocks give you more profit compared to portfolios that have large-cap stocks.

Quality

Quality is stable earnings, low debt, strong corporate governance, consistent asset growth. Investors can identify high-quality stocks by utilizing common metrics such as debt to equity, return to equity, and earnings variability.

Momentum

It is known that stocks that have previously outperformed their expectations tend to show strong returns going forward. Momentum needs to be monitored between 3 months to 12 months frame.

Volatility

When trading the market, you need to understand that the stocks, which have low volatility, earn better returns than assets with high volatility.

Steps in developing the perfect factor-based strategy include:

- Coming up with a trading idea or an investment strategy that you plan to use.
- Developing various factors to serve as your basis for making the perfect decision.
- Acquiring the relevant data.
- Analyzing the various factors and building the perfect strategy.
- Evaluating and backtesting the strategy.
- Implementation of the strategy.

Mean Reversion

Mean reversion works on the assumption that there is an underlying stable trend in the price of a security and that the price will fluctuate randomly around the trend. It also assumes that values, which deviate far from this trend, will always tend to reverse the direction and then revert to the initial trend.

Therefore, if the value is very high, we expect that the price will go back down and then if it is unusually low, it will go back up.

The main issue is, how do we identify the original trend value? This is the essence of the strategy that we discuss.

To get the underlying trend, we calculate a long-term moving average, say for 90 days and then use that as a stable trend. When the value falls below the underlying value, we expect the value to revert up. Therefore, if the price is too low, we expect it to spring back up, and it is the signal to buy.

Similarly, if the value goes way up, and we expect that the price will fall towards the underlying value, then it is the perfect signal for you to sell.

To make a successful sale, you need to make sure that you know your indicators. Here are a few indicators that you can use to determine when the time is right to make the sell or buy.

- Relative Strength Indicator (RSI)
- Bollinger bands.
- ConnorRSI.
- Moving Average Stretch.
- The number of days down.
- Rate of change.

When coming up with the strategy, you need to have targets. You can use many metrics to come up with the goals, but the most important one is the Compounded Annual Return.

Application of the Mean Reversion Strategy

To use the mean reversion strategy successfully, you need first to select the specific currency pair then comes up with an average price. Make sure you consider every trading range available,

including long-term and short-term.

When using mean reversion, you take all the guesswork out of any trading. As a new trader, guessing is one of the things you do in the first few months of trading, and this usually results in losses. These losses go ahead to affect the faith of the trader in their trading abilities.

When a currency pair price holds way below the average price, this is the perfect indication to buy. This is a signal that the price will eventually raise. Alternatively, when the market price is above the average price, then it tends to revert to the mean, signaling the time to sell.

When Should You Use Mean Reversion?

Using mean reversion is ideal for short-term trades that are visible in highly volatile conditions. Don't use mean reversion with long term trades because you will lose money. The strategy is ideal for short-term trades that won't last more than a few minutes or hours.

When using the mean reversion strategy, don't use charts that have highs or lows. Such long dips aren't common, and they easily stand out. The presence of long dips indicates that the price will not revert soon.

The best trader for this type of strategy is one that is willing to take high risks for greater rewards. To enjoy what the strategy has to offer, you need to switch off any emotional influences and base your decision on facts.

The Benefits of Mean Reversion

These Mean reversion strategies have a very short period of between 3 and seven days. This means they perform well during high market volatility.

Demerits

During low volatility, the trades remain in cash, something that can be frustrating. These work best without stops, and it means you have to wait for the price to bounce back.

It can also be hard to place a trade because the charts usually look

congested.

Scalping

Scalping represents one of the most common strategies that are ideal for short-term retailers and institutional traders. Rather than going for huge gains from single trades, scalping opts to optimize the win-to-loss ration by spreading them across many trades. This process uses small trades that give small profits that you add up to be huge eventually.

The trading strategy is ideal for traders who run short-term trades but who have access to a huge capital outlay. To be successful, you need to have a high level of discipline, especially when you aren't using any automated trading platforms to buy and sell securities.

The Benefits of Scalping

Limited Risks

These strategies are designed to reduce risks in a great way. Single trades have a high risk; therefore, it is prudent to spread the risk across different smaller trades so that you don't lose all your investment on a single trade.

No Need to Wait for Direction

This non-directional strategy won't require a specific stock to move towards a given direction for you to benefit. So, you can easily profit from movements to either side – up or down.

Easy Automation

These strategies are easy to integrate into a trading system of your choice. The main reason behind this is that the strategy is based on clear-cut technical data that is easy to be computed.

Drawbacks to the Scalping Strategy

Requires a Higher Minimum

This strategy requires you to have higher minimum account values so that you can comply with trading rules and generate profits to achieve your goals.

Higher Costs

Since you are running more than one trade at the same time, you stand to pay more trading costs eventually.

Need for Control

This strategy requires a lot of leverage to make enough profit. This makes it necessary to have a high level of control so that you avoid losses.

Implementation of the Scalping Strategy

When you decide to use the scalping strategy, you have to follow a few tried and tested strategies:

- Determine the technical indicators that you plan to use and define how you plan to use them.
- Run a backtest so that you see how the strategy would have performed when used in the past.
- Paper trade the strategy you have chosen using broker quotes.
- After choosing the strategy, go ahead to make any necessary revisions to the strategy o that you reduce the risk that is involved.
- Once the strategy is in place, the next step would be to start using the strategy while you monitor the results. Make sure you keep abreast with any news that might affect the market.

Sentiment Analysis

Sentiment analysis is a certain way to understand the attitude of traders, and it is considered a top strategy for many people. This premise works because every trader has his or her opinion regarding the way things are working in the market. Using the sentiment, the trader decides which direction to trade – whether to buy or sell.

Every trader has thoughts and opinions, and these are expressed through the position that they take in a trade. This helps form the market sentiment regardless of the information out there.

The only problem is that as a retail trader, no matter how strong you feel about any trade, you cannot move the market in your

favor. For instance, if you feel that the dollar will rise or the price of a stock will soon double, yet everyone else isn't of the same thought, you don't have much to do about it.

As a trader, it is up to you to perform sentiment analysis. It is up to you to determine what the market is feeling, whether it is bearish or bullish, then you have to incorporate this perception into your trading strategy.

You can choose to ignore the market sentiment, but remember that it is your choice, and you might end up losing. Remember what matters is not what you feel or think, it is what is a consensus by the market, and this is what decides the price of the security.

The market sentiment can be positive, negative, or neutral. The basis is based on world events, macroeconomic reports, technical analysis, fundamental analysis, and non-economic reports.

There are two types of sentiments:

Bullish Sentiment

The sentiment is bullish when the attitude of the market is positive. In a bullish market, it happens when the prices are expected to rise.

Bearish sentiment

The sentiment is bearish when it is negative. In a bear market, it happens when the prices start plummeting.

However, the sentiment trading can also be mean reverting or contrarian, whereby it is opposite to the sentiment in the market. The theory works on the basis that when there is intense crowd behavior regarding a certain trade, then it gives rise to exploitation and the resulting trade will be followed by a fall or a rise in prices due to corrections and vice versa.

Sentiment Indicators

Sentiment indicators are the signals that tell you where the market opinion lies. The indicators can be qualitative such as opinion polls. Many companies offer the information you need that is gleaned from marketing and trading professionals. These conduct polls, surveys, and go ahead to publish them.

The polls that the companies conduct are done on a regular basis, and the reports are posted or sold as a package. They are compiled in graphs and visualization to make sure you understand each sentiment.

Additionally, you can also use quantitative market data such as trade volume, security price, and open interest. Some of the indicators include:

- Arms Index
- Put/Call Ratio
- VIX
- Mutual funds cash position
- Margin debt
- Short interest ratio

Machine Learning-Based Trading

In this form of Algorithmic trading, Artificial Intelligence takes center stage when it comes to predicting the range of price movements, usually offer a short time. The advantage of using this method is that humans develop the initial platform, and the AI develops the trading model and improves the same over time.

Most of the models that have been used before have been static, meaning they don't change with the conditions in the market. ML-based models get to analyze a huge amount of data at very high speeds and then improve the system depending on what happens.

Some of the models used in trading include:

Bayesian Networks

This is a form of machine learning that is used to predict the trends in the market while utilizing various machines. The network uses a form of computation that runs across hundreds of computers and machines to get the right computation.

The AI can come up with a random collection of stock traders and then go ahead to test the performance historically. After this, it then looks for the best-performing systems and creates a set of traders. The system then repeats the process several times then ends up with a digital trader that can fully operate on its own.

Smart Beta Trading

Beta means a measure of the volatility of a portfolio or security, as compared to a broader market. In a market such as the stock market, individual stocks get ranges according to how much they deviate from the beta.

The first smart beta exchanged traded fund came on the market in 2003, and after this, the number of products available to the market grew exponentially. The main reason is that many investors are looking for various free alternatives that are low priced to give them an alternative to active fund management.

This strategy offers you the chance to run passive investments, with the focus being lowering costs and making a profit.

The trading pattern is away from the traditional indices that weigh down the constituents by the size on the market. A smart beta index might be titled towards smaller companies that tend to outperform eventually. The main stocks that benefit from this approach are value-based earnings, those that have momentum and those that are less volatile on the market.

The response of the traders was immense, and there has been a proliferation of these products on the market, which means more and more investors are investing in the indices.

Smart beta indices differ from traditional trading strategies in the sense that they apply a series of objective rules to each index in the company. Companies then get ranked based upon how they score on the specific factors.

One of the major benefits of using smart beta ETFs is that it mitigates the challenges that result from trading market cap-weighted ETFs. Therefore, instead of screening companies depending on their size, the smart beta uses screens that are based on the ability of the company to achieve more.

Many of the traders that opt for this trading method are those looking for factor diversification. However, not all smart beta strategies are alike. Investors ought to carefully consider the various ETFs and assess what indexes and biases each use, with the sole aim of choosing the best as per the goals in hand. To develop the index's

underlying holdings, traders use low volatility, quality, momentum, size, and value to determine this.

Chapter 7:
Backtesting

Nearly all the research that is related to algo trading is empirical. This means based on past observations and experience in the market. This is in contrast to the theoretical research that is based more on assumption, logic, and mathematical frameworks.

Backtesting involves testing a trading strategy that you are considering by simulating it on historical data to gauge how effective the strategy is in the present times. Conducting the test is an integral part of coming up with the right trading technique and in the development of the best trading system for your goals.

Backtesting works on the theory that whatever worked before will most certainly work in the future. The vice versa is true – if a system failed in the past, then it will most likely fail at the moment.

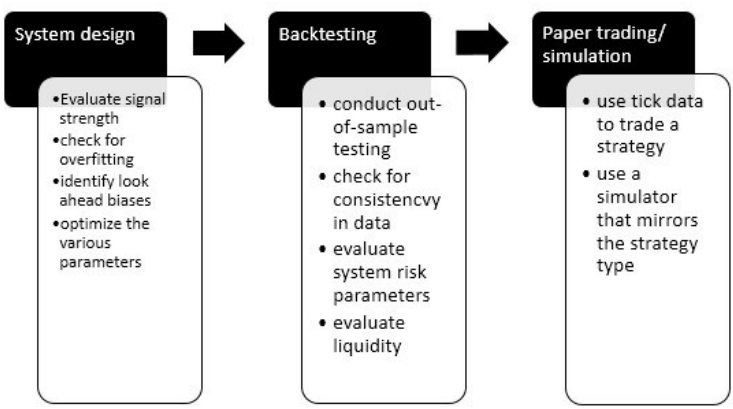


Chart 3: *The position of backtesting in trading Algorithmic development*

Comparing statistics from a historical perspective, you can determine if a strategy you are considering will be effective if you put it in use. If it isn't effective, you have a chance to identify gaps in the strategy, then go ahead and customize it to suit your needs.

Remember though that backtesting analysis takes time, especially if you need genuine results. Before you can come up with the right results, you need first to assemble a huge amount of data from genuine sources.

Backtesting is vital in that it allows us to test numerous variations if models or ideas quickly, effortlessly, and therefore provide immediate feedback on how the various systems performed in the past.

Reasons for Backtesting an Algorithmic Strategy

Filtration

Filtration involves setting up a strategy pipeline so that we can filter any strategy that doesn't meet the set down criteria. Backtesting provides the trader with a filtration mechanism because we get to eliminate any strategies that don't meet certain performance needs.

Modeling

Backtesting allows the trader to test new models in a certain market, for instance, order routing, transaction costs, liquidity, latency, and many more.

Optimization

It is a well-known fact that strategy optimization comes with a lot of biases, but backtesting allows the trader to increase the performance of a strategy through modification of the quantity or values of various parameters that are associated with the strategy.

Verification

When you filter the strategies, you end up with ones that you think work best. However, some aren't correctly implemented, which requires that you use a strategy to eliminate these. Backtesting can make sure the strategy has been properly implemented according to set criteria.

Before we can proceed any further, we need to look at the advantages you stand to gain when you perform backtesting.

The Advantages of Backtesting

Ability to Test before Deployment

Backtesting strategy tests the technical analysis of a strategy to be applied in the trading. By using this method, you can test the

capability of any given strategy and check whether similar results were achieved in the past.

Once you have the results that you are looking for, you can compare with current figures so that you can determine whether the strategy gives you a predictive value or not.

Builds Confidence

Backtesting your trading strategies help build up confidence among a trader regarding a designed strategy before you can implement it in the current market. It works on the premise that if the strategy has worked before, then, it can work successfully in the future.

Adds Value to a Proposition

Properly executed backtesting identifies whether an idea has a persistent edge or not, and under what conditions it can manifest. By controlling the different parameters, you get to test how robust the idea is. From these, the trader is able to identify any specific market conditions where the edge is tradable or significant.

Helps You to Understand the Win-Rate Percentage

Backtesting reveals the likely win-loss percentage and tells you the maximum winning and losing percentages

Know the Expected Results Beforehand

Understanding the various issues regarding the Algorithmic helps you to determine under what conditions the idea is tradeable.

Limitations of Backtesting

One of the top limitations of backtesting is that it can give you overconfidence due to the way the system performed in the past. There is always a danger when you believe that a system will work the way you expect it to do only for it to fail. Remember the market is a very complex system that will never show traders the same results twice. Even if you perform the perfect backtest with the ability to forecast into the future, you will most likely see a discrepancy between the actual results and the backtest results when you go live.

Factors to Consider before backtesting

Before you go ahead and start the backtesting method, you need to consider various points.

1. Past Results May Not Guarantee Future Success

Backtesting focuses fully on historical information to predict what will happen in the future. However, you need to understand that the results that are achieved in the past don't necessarily guarantee success in the future as well. Markets are volatile and might change anytime, which might affect the performance of the results that have been derived using backtesting.

2. The Results Aren't Exact

In any market, for example, the Forex market, there are so many variables that affect the way the trades run. For instance, the use of different spreads by traders might influence the results. Volatility also affects the results because you are using two similar strategies in different contexts. The good thing is that when you use the Algorithmic method in trading, you end up with fewer errors compared to doing everything manually.

3. Running Live Trades Is Different

Running live trades in the present market is different from working with historical data. There is a huge possibility of the trader reacting too slowly or committing many mistakes to catch up with the current marketing environment.

4. Variable Results

These come up when you decide to trade large amounts. This is because trading large often yields different results every time. Additionally, large orders have the uncanny habit of moving the price of given security either way.

Additionally, backtesting is fraught with a lot of biases. Let us look at a few of these biases in the next section.

Types of Backtesting

There are two types of backtesting strategies that we can try out – automated and manual backtesting. Automated backtesting works on a code that is developed by the user, whereas the trades are

automatically placed depending on certain criteria. On the other hand, manual backtesting requires you to study charts and conditions manually and then place the trades according to the rules that you come up with.

If you understand programming languages, then you can undertake automatic backtesting. However, you need to keep in mind the prevailing market conditions and tune your strategy and code to fit the conditions. Failure to do this might lead to erroneous results due to changes in the market conditions.

Key Pointers to Consider when Coming Up With the Right Backtesting Strategy

Before you come up with the right backtesting strategy, you need to make sure you consider the following points:

• *Pick the Right Market Segment*

You need to choose the right market segment so that you come up with the perfect backtesting strategy. You need to consider various factors that include the risks that you are willing to take as well as risks that are in the market. You also need to consider the profit you are after as well as the time you will be investing in the market.

Look at the period you plan to invest – short term or long term so that you decide the assets that will be suitable for your trading method.

• *Consider the Data*

The prices prevailing in the market are vulnerable to various factors and keep on changing depending on the situation going on. These factors include monetary policies, annual company reports, inflation rates, and more.

The main thing that you need to consider is that the market will not always behave similarly and this is the reason why you need to test the strategies so that you understand how it will perform in different conditions.

• *Get the Right Platform to Code*

There are various platforms that you can use to perform backtesting

on the data. We shall look at the platforms later on, but briefly, you need to know how compatible the platform is to the kind of data you choose.

- *Compare the Platform with Benchmark Parameters*

Backtesting is performed in line with how a trading strategy will perform on future data. This is done by measuring the performance of the strategy on historical data. After this, you need to gauge the performance of the strategy based on various parameters such as the success ratio, and more.

The Process of Backtesting

After you consider the points discussed above, the next step is to create a trading strategy that is based on historical data. You can build your model using VBA or Python and then test it later using R. Testing the model on a simulator is ideal because it gives insight into any issues that were faced a few years ago. The simulator acts as a real exchange that can be configured to suit different market conditions.

Backtesting platforms

Apart from visual basic, you need backtesting platforms that are specific for a given strategy. Let us look at the different platforms that give you the capability to run quick backtesting functions.

TradeStation

In this day and time, it takes more than just having flashy software to trade the markets successfully. Instead, you also need to have access to data and the right investing strategy to give you an edge over other traders. These can be helped by using TradeStation, an investing platform that helps you when you decide to perform backtesting.

TradeStation focuses mainly on helping traders get the right trading strategy. It leverages technology and access to data to help you as a trader make the best decisions. However, it might not be a walk in the park for newbies, and it can turn out to be very confusing.

The minimum investment amount on this platform is $500, and you have to pay a commission of $5 per trade. You can invest in Penny

stocks, stocks, mutual funds, EFTs, futures, and bonds. The types of accounts that you can open include IRA, Taxable, custodial, and trusts.

The platform makes money when you place a trade. Each trade costs $5.00 per equity you trade. The platform needs you to be an active trader to make it work. As a trader, you must make at least 50 trades each month or trade more than 5,000 shares each month, or maintain a minimum balance of $100,000 or you stand to be hit with huge fines.

The funding minimum for the accounts varies depending on the trading class. For EFTs, you need a minimum of $500 to use the platform. Options require a funding of $2000.

When you log into the platform (via the web or downloadable platform) shows you featured videos, the economic calendar, links to workspaces and the company's Twitter feed. You can download the extensively customizable desktop platform. The web platform has most of the features and is easy to customize to your liking.

All the data streams on the platform are in real time. You get to place, modify, or cancel a trade using keyboard shortcuts. Customizing the trade is easy, all you need to do is hover your mouse over a bid, and you will use a trade ticket that you can modify before submitting the order.

The Advantages of Using TradeStation

Easy Coding Language

Traders that want to have the edge over their competitors need to learn a programming language. The good thing is that TradeStation uses EasyLanguage, a simple coding language that you can easily master. It is a mix of HTML and SQL. It becomes easier if you have prior coding skills.

Instant Market Updates

TradeStation's RadarScreen gives you access to real-time data sets on 1000 symbols. This gives you an edge similar to all other technical traders. The platform focuses so much on high-quality market data to help you get the perfect trading strategy. Their platform is also stable and will remain available in market changes.

Technical Analysis

This platform has more than 40 years of historical data available for you to use in your simulations. This means it is perfect for backtesting several strategies using the data. You can also utilize the access to this data to study any technical trends. You can develop your automated trading system using the technical analysis tools the platform offers. You also get to generate income using the fully paid stock lending system and grow your trading skills with the extensive training options.

It Is Fast

The speed of execution of commands makes it an ideal platform for traders looking to perform backtesting on their strategies. It also gives you accessibility to indicators that you can modify depending on the strategy in focus.

Discussion Forums

If you are looking for some support and answers to questions, you can ask them on the active forum that TradeStation offers. This platform has integrated a forum in the whole ensemble. Some of the discussions that go on in the forum are helpful and based on experience.

Disadvantages

Requires Programming Skills

For you to take advantage of the platform better than other traders, you need to have some basic programming skills. Although they offer various out of the box solutions, take time to learn some programming, and you will see returns.

Lack of Expert Analysis

If you expected to get expert analysis for the stocks, then you will be disappointed. The platform doesn't give you any analysis to help you pick the right stock; instead, it emphasizes more on using indicators to help you get the right decision. This means even those traders that are serious and need to use value-based strategies might not get what they need on the platform.

Expensive Courses

Most of the tutorials that the platform offers are free, but it also

offers some expensive courses that might not be affordable for most newbies.

NinjaTrader

This came into being in 2003, and it offers brokerage and software services to active trader seeking to test this system or run active trades. You can use the platform for free, especially when you want to perform market analysis, charting, and trade simulation. However, you need to have a license when placing real trades and accessing the premium features such as placing advanced order types, backtesting, and automated trading. You can decide to lease or purchase the software. The features that allow you to analyze trade activity using volume bars, order flow, and market depth need you t have a lifetime license.

On the flipside, you don't have a lot of options when it comes to buying and holding trades and investments since the platform doesn't give you so much in terms of research.

The platform is ideal for active traders that plan to trade in Forex and futures. This platform gives you great options for real-time technical analysis, charting, and customizable technical indicators.

NinjaTrader gives you a chart-based order execution tool and thousands of apps as well as third-party add-ons for you to use. While it was meant for traders looking to trade futures, this company has also partnered with other brokerages so that you can trade options, Forex, stocks, and CFDs.

NinjaTrader gives you a platform with clean, fully customizable charts. You can easily change the colors of the charts, bar spacing, fonts as well as the layout of the chart windows. You can easily add strategies, technical indicators, and drawing tools that are easily added within the chart. The charts also support different bar types, including tick, time-based, range, and volume bars. It also gives you a wide range of chart styles to choose from – OHLC, candlesticks, Mountain, and Kagi Line.

The platform gives you easy to use interfaces. One of the notable interfaces is the Chart Trader, which allows you to manage and plan your charts right from the chart. You can handle all types of order types from the platforms including limit, market, stop limit and stop

market orders, as well as one-cancel orders.

If you are a fan of automated trading, this platform gives you semi-automated features that you can use to manage your positions, or you can decide to automate your engagements using the Automated Trading Interface entirely.

Real-time data is available at a cost, and it depends upon the kind of data feeds that you require. You pay for the data in a monthly cycle. You can replay the data on a tick-by-tick basis using the platform's replay option. This is ideal for trade practice, backtesting, and other kinds of research.

The platform is easy to download and free to install. The installation process is simple and straightforward, and once you launch the platform, you can add charts, indicators, and customize the colors. The process can be tedious for some people, especially if you are used to fully automated platforms.

Using the system is easy, and you have access to a huge number of tools and resources. The good thing is that the platform hosts free webinars to get you started.

One of the best features of this platform is it gives you the capacity to simulate trades. This ability comes with a demo account and a profit/loss summary. This can be ideal for backtesting as well as for new traders who are looking for a platform to practice what they have learned.

Apart from market depth tools and charting, the platform offers limited resources to research within the platform. However, due to its focus on active futures trading, you get all the tools for these trading. You can customize the indicators; the platform, as well as other features, can be customized to a granular level. Sadly, there are no essential tools available for you, notably missing are news, financial statements, and data that are ideal for such a professional platform.

Advantages of NinjaTrader

- This platform gives you excellent technical analysis and charting tools to help you get the necessary insight into the trades.

- You have access to over 1000 apps and add-ons that make your trades easy and fast.
- You can sign up for a demo account so that you try the platform and understand what you are getting into.
- Disadvantages
- The platform charges high fees to sign up, which might be an obstacle for newbies.
- The platform gives you easy setup, and the only downside is that you have to use another broker to run other trades.
- You don't have access to news feeds, fundamental data, and research which are missing on the platform.
- It only has a narrow focus and only supports Forex trading and futures. However, you can use its partners to trade stocks and other securities.

AmiBroker

If you are a trader looking to run backtesting on a strategy, you might have heard of AmiBroker. It is a comprehensive platform that gives you a host of backtesting options, charting tools, and much more.

The platform offers some of the best backtesting tools that you will ever come across. Monte Carlo simulations and walk-forward testing are just a few of these tools that you can use to develop new strategies for your trading needs. Additionally, the built-in programming language makes this platform a versatile one for traders that have some knowledge in coding.

However, the platform is available for Windows OS, though Mac users can use it via windows VM.

The platform offers various pricing options depending on the package that you choose. The standard version of the platform costs $279 though it comes limited to 1-minute charting intervals that might not be ideal for intense trading. The version also comes limited to two CPU threads and only comes as a 32-bit program.

If the standard version isn't ideal for you, then go for the professional plan that costs $339 and gives you unlimited real-time trading and data as well as intra-day charting intervals. This license also gives you access to the 64-bit version of the program.

For $499, you get access to the ultimate pro pack that comes with other types of software to make your trading experience more realistic. Here, you get to download real-time data, and you can create custom code for your strategy.

AmiBroker Features

Technical Charting

You get access to highly versatile charting capabilities. You can add a variety of analyses to the charts and switch between multiple interfaces. You also have the option of customizing the chart appearance as you wish.

You also have access to a variety of drawing tools that you can use within the charts, such as Fibonacci patterns and regression channels.

The Formula Editor

You have access to the AmiBroker formula Language (AFL) that allows you to use templates with an in-built variable rather than adding actual values. This is ideal for experienced traders who need a quick reference as they design a formula. However, newbies will find the going hard because of the lack of basic formulas to use.

The editor allows you to check the code that you have before you execute it. This is made possible by the in-line syntax verifier that makes everything easier for you. Additionally, you can use the drop-down list of functions that make it easy to add to any code that you are running.

To assist you in making decisions further, you can ask questions in the online support forum, especially for advanced functions.

Technical Analysis

Once you have your formulae set up in the editor, you can use the various analysis functions that the platform offers. This is what makes the platform ideal for backtesting because you can run scans at a very fast speed on a single CPU. The results of any analysis are displayed in an excel table that you can export to a spreadsheet.

You also can define backtesting data such as the portfolio size and

sub-portions. The downside is that these settings can be hard for newbies who need a steep learning curve to understand them.

Backtesting Features

For traders looking to run backtesting on a strategy, the presence of various features makes the whole operation fast and simple. Using a screener in the platform, a trader can easily identify potential trades using a formula-defined trading strategy. This is ideal for end-of-the-day traders as well as swing traders. The scan quickly allows the trader to locate trades, buy and sell them or to follow signals that have been defined in a formula.

Among the features, you will find that the walk-forward and parameter optimizer portions make the platform very powerful for backtesting. With the code already set up, you have the option of defining multiple parameters, each requiring various values.

The optimize analysis helps you determine a profitable combination of parameters for a formula. This is invaluable for developing new trading strategies.

Layout

Even with the affordable pricing, you find that the platform isn't used widely even by moderately experienced traders. This is because the learning curve towards beginning to use the platform is steep and requires several days and tutorials. The sad part is that there is little that has been done to help traders master the interface, for instance, you might not be able to know where to start the process of conducting an analysis or designing a formula. You don't have access to predefined formulas and functions to get you started.

Instead, you have to sink several weeks of your time into learning the coding language so that you can design multiple parameters. Failure to learn the language makes it hard for you to use the platform to design and test new strategies.

This isn't made easier by the layout at all, because the interface is crowded, and the menu buttons are small, which makes it hard for you to know the available options. This layout means you have to move from one screen to the next unsuccessfully.

The platform has been designed with advanced traders in mind. The platform is suitable for developing and testing new trading strategies, which is usually limited to experienced traders. Using the platform requires a well-developed knowledge in technical analysis and coding.

Advantages of AmiBroker

- The platform is surprisingly affordable, considering the analysis power that comes with it.
- You have access to handy technical charts.
- The scans, walk-forward tests, and backtests are incredibly fast.
- You can use up to 32 CPU threads.
- You can optimize a strategy using multiple parameters.

Disadvantages of AmiBroker

- The layout is jumbled up, and it doesn't provide any guidance. The menus are also small, making it hard to navigate.
- It has a steep learning curve for the built-in coding language.

Backtesting Parameters to Use to Evaluate a Trading System

Before the trading system comes into force, you need to understand what parameters you need to test. Here are a few to consider.

1. Total Profit or Loss

Total profit or loss helps you to determine whether the trading strategy in question led to profits or losses. You get to understand how much profit or loss can be achieved through the strategy. This is attributed to analyzing the historical data that the strategy was tested upon.

2. Average Profit or Loss

This denotes the level of profit or loss that you can incur in a certain unit – days, minutes, or hours or over a specified period.

3. Maximum Drawdown

This can be used as a measure of the risk in a trading strategy. It denotes the maximum drop in the value of an asset from its peak value. This, in turn, helps us to assess the kind of risk involved and the loss that we can incur from the trading strategy. Through this, you get to decide whether the risk is worth taking or not.

4. Success Ratio

This refers to the number of trades that you won or profited from concerning the number of trades that you lost or incurred a loss on. The ratio is an important indicator that allows you to understand how well the trading strategy is working for you and to what extent you need to optimize or update it to reap maximum benefits.

5. Sharpe Ratio

When you have two strategies that you are assessing, and you find that they give you equal returns, then the less risky strategy can be considered better than the other does. Such a measure is referred to as a risk-adjusted return, and you use the Sharpe Ratio to calculate it.

Backtesting is one of the biggest features of Algo trading because it allows you to test strategies before you deploy them in the market.

Common Backtesting Mistakes to avoid

While backtesting is one of the best aspects of Algo trading, it is not always successful. The results of these errors mean that you will skew your performance from the actual results. Let us look at the common pitfalls of backtesting and what you can do to avoid them.

1. Survivorship Bias

When you run your backtest, you tend to leave out some companies that no longer exist in your selection. Remember that after building your strategy, you go ahead to try and run the test within a specific period in the past. However, the sad thing is that most of the platforms you use to run the test will fail you at this point, leading to this bias.

The test you run will only include the companies that are available at the moment and exclude the ones that aren't in operational or the ones that have gone bankrupt. This means that the results you

get won't be as complete as you expect them to be.

By excluding the companies, you find that the results that you return will be skewed much higher than the expected results.

To solve this mistake, you need to find a platform that doesn't support this bias. The platform will make sure the test includes all the companies that were there even in the past.

2. In-Sample Bias

When building the ultimate strategy, most traders only focus on a single period and ignore the rest. You take this period to be the perfect time to alter all the rules and parameters of the strategy so that you can make it perfect.

Issues arise when you use the period and ignore other periods for testing purposes. For instance, when you decide to test in a bull period, your strategy will only work in a bullish market.

It is, therefore, best to refine the strategy and test it over many periods. Try to run the tests in times of low volatility as well as high volatility, bear and bullish markets, and when you are out of range as well.

3. Lookahead Bias

This is a big mistake that many traders fall into. It is easy to look into the future when, in fact, you have all the necessary data seating in front of you.

When running your backtest, make sure you look at the relevant trades that you can use for the day. For instance, if you are making trades on the closing price, you might not be able to make trades until the following day.

4. Missing Out On the Little, Important Things

The use of backtesting is good because it allows you to set up the strategy that you wish to test, click on a couple of buttons then calculate the best results. However, it isn't the same thing when you are trading live. You have to look at various aspects of algo trading, such as feasibility, liquidity, and transaction costs.

It becomes hard to get the right position when you try to buy too

much stock that lacks a lot of volume. Backtesting won't identify the anomalies, which means you have to set up the framework to consider the size you are running on the market.

Many traders ignore the transaction cost, forgetting that this cost builds up over time. This is entirely true if the trading strategy you choose aims to enter and then exit a lot of positions very fast.

5. Factor Mining

Given the access to a lot of data and computing power at the moment, you can get the best strategy that works with the backtest platform you have chosen. Additionally, when you use highly correlating data, you end up not adding any diversification to the current portfolio; thus; you end up with an erratic performance.

6. Limited Data

The more the data you have access to create and test the model, the better the results you expect to get. Longer data history improves the stability of the model by cutting down on reliance on market conditions that are usually prevalent over a short period. The robustness of the model increases when the data you are using covers multiple business cycles.

7. Ignoring Market Impact

You need to know that any act of trading directly affects the market price. However, historical data doesn't include all trades, and therefore, it is not an accurate representation of the price that you would get when trading.

So, be sure to anticipate that the price will move against your expectations whenever you trade.

8. Trusting Complex Models

Many traders put their trust in complex models that are often overfitted models. Simple modeling approaches that are woven from basic ideas usually provide the best models. So, strive to come up with a strategy that is built from a few factors that are combined with simple rules so that you get a result that is less sensitive but robust rather than a model that considers many factors.

9. Overlooking implementation costs

Many traders overlook the cost of implementing the strategy and end up stuck. You need to consider these costs in their entirety. For instance, make sure you account for the commissions, expenses, bid/ask spreads as well as the market impact.

10. Not Writing Down and Following the Process

For success in anything you do, you need to have a well-defined process in place. This begins with writing down the trading system. You need to note down a set of parameters that include the name of the strategy, the pairs you plan to test the strategy on, the indicators that are used complete with their settings, the timeframe, the risk per trade and the entry and exit signal.

Apart from the main parameters, make sure you add some optional parameters to use. Failure to do this means you won't know how well the rules you have work.

11. Giving Up even before you Begin

Many people drop their test when they fail to make the profit they set out to achieve. Once they realize that something isn't going their way, they stop the current test right in the middle of the data and then try a new set of rules or jump to a completely new system. Big mistake!

When you stop the test in the middle, you don't get a true reflection of the potential of the system at all. The reason the test might be failing might be due to changes in the market that you failed to capture in the new system.

12. Failure to Track Your Results

It is important that you track your results and know exactly where you are at any given time. You need to see the total return on across all your trades. Many people check out a single trade and end up being discouraged. However, when you consider the total trades, the results will impress you.

13. Hindsight Bias

If you are moving past the entry to signal and peeking at what will

happen in the next step, then you are cheating. This affects your results and will give you a wrong misconception about the whole system because it looks better than it is. The only way to appreciate the results you get on a backtest is to use simulation whereby it is as if you are trading on a live platform.

14. Using inaccurate data

Inaccurate data gives you false predictions that will end up messing up the system. The results you get will be jacked, and these can be inaccurate timestamps, bad ticks, or other bad data.

It is vital that you get data from a genuine vendor. Comparative analysis of the different vendors is also a good idea because you get to know the values that you need to accept and the ones that are way out of range.

15. Using Poor Testing Tools

Using the right tools gives you the expected results from your backtesting effort. When you don't use the right tools, you end up with wrong assumptions. If you are a serious trader, you need to be ready even to spend some money to get the right tool.

Chapter 8:
Developing an Algorithmic Trading Strategy
The most successful strategies are based on a mix of both technical and fundamental factors. Building a successful Algorithmic strategy needs a lot of patience and time, as well. Let us look at the various tools and methods to help you come up with the right strategy.

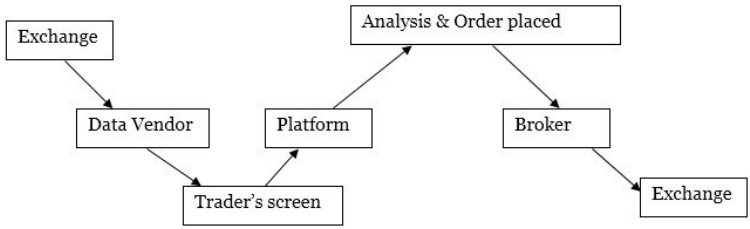


Chart 5: *Developing an Algorithmic trading strategy follows a set of dynamic steps .*

First, we have to understand the market conditions and then look at the features of the various assets we would like to trade. Next, we need to set the strategy that represents the best fit for the trading background that we have identified. After this, we have to backtest the strategy so that we evaluate how it might have performed in the different conditions in the past. After the backtest, we go ahead to adjust the strategy based on the backtesting results, after which we implement the strategy.

Here is a rundown of the various steps to plan and implement the strategy.

Ideation Phase

This is more like finding an incentive that will drive your Algorithmic behavior. The Algorithmic might be aimed at running trades or identifying the best trade to pick – at the end of the day, you need an incentive that will drive the project towards a certain direction. Are you looking for more successful trades? Higher returns? Higher satisfaction? How can you measure the results? These are questions you need to answer earlier in the process so that it guides you the entire process.

Here, you wish to determine the type of trading strategy that will

be ideal for you. There are endless opportunities that you can experiment with depending on your goals. These include market marking, spread capture, arbitrage, and more. In all these, there is no better strategy than the other; it all depends on the risk vs. reward profile and how best you implement and test the system.

This phase is the easiest and best place that requires broader input from a number of sources. Talk to your staff, consult with managers and talk to experts to find out how you can achieve your goals.

There are various places to find ideas, including quantitative finance papers and trading websites. Some of the most popular include Quantart, Wilmott, Quantopian, QuantConenct, and SSRN.

Steps:

- Identify the need for the Algorithmic
- Establish any Algorithmic incentives
- Discuss the optimizations and measurements that relate to the incentives
- Communicate your objectives to data scientists.

Expected outcomes

- Considered intentions
- Clear research and design objectives

Research and Development (R&D) Phase

This is the stage whereby you go from the idea to identifying the specific Algorithmic that you have the capacity to implement. This stage is vital to the whole process and though it might seem obvious to you, it isn't that direct since you cannot move from the ideation phase direct to the prototype. If you move fast, you will end up with an Algorithmic that easily breaks, so you need to take your time.

For each strategy, you have various viable options to use as well as well-documented implementations of each stage. The best performing strategy is also the one that will take most of your time. Additionally, what might work with one strategy might not work with the next one. The only thing you need to do is to iterate, evaluate the results and adapt.

Steps

- Identify the right R&D process to identify various Algorithmic strategies.
- Constrain the parameters of the process so that you focus your intentions on a specific strategy.
- Present your findings to the development and product team.
- Evaluate the performance of the chosen Algorithmic with the whole team.
- Using the initial idea, select the best-performing Algorithmic.

Expected outcomes

- Choose the best Algorithmic to implement
- Share the information you have on the chosen Algorithmic across programmers, development and product teams

Product Development

When you have run the R&D phase successfully, you now have all it takes to come up with the Algorithmic. You now have the specific objectives that can be used to create the system. You are taking the product features then mapping them to the technical requirements.

At this point, you have two documents: the initial idea as well as a trial implementation of the desired Algorithmic. Here, the development and product teams have enough contexts to come up with the system.

However, they need to maintain a lot of quality in the Algorithmic the whole time.

Generating trade Signals

When you come up with the strategy, you need to know when you will enter the market and when you will exit it. These are the entry and exit signals, respectively.

It is easier when you are holding one position, but when you are handling multiple positions, it becomes harder and complicated because you have to try and not contradict yourself. Entry signals are much easier to create, and the strategy will give you the trigger

to allow you to trade. On the other hand, the exit signals are much trickier because you need to take smaller wins. The decision to exit depends on how long you hold the position.

Steps

- Connect the Algorithmic to the desired system architecture.
- Create the required user stories.

Expected outcome

- Algorithmic design

Implementation phase

This is where the development team takes over and implements the whole process and makes it into a product. Make sure you have good communication between the development and product team during the phase so that there is consistency and the quality is maintained.

Steps

- Implement the various objectives
- Evaluate and adapt

Expected outcomes

- Development of the Algorithmic code

Testing Phase

Once the new Algorithmic is in place, you need to test it against the initial incentives. This means you need to test the implementation and see if it actually does what you want it to do. The evaluation needs to be subjective, with the aim of tuning the parameters and fixing any bugs that might arise. This is the time you also involve the users.

Backtesting the Model's Parameters

Backtesting means that you test the model against historical data from way back before you trade with the strategy live. Backtesting, as discussed above, involves simulating the results in a controlled

environment to see how the model performs in various conditions. You can also experiment with the parameters; for instance, you can choose to use five lag periods instead of one and see how the results look like.

For you to get the perfect profitable strategy, you might be forced to run many iterations and configurations. You have to change many factors to get what you need. Remember that small changes to the parameters can usually lead to large and unexpected impacts. This is the reason why you need to collect the data, test the models against the data, and then update the strategy depending on the new data.

Look at the various risk factors

No model can perfectly predict the future. The model that you are coming up with is simply a representation of what is happening in the market. You also need to look at the transaction costs because it can mute the profitability of the strategy, especially if you didn't account for transaction costs the right way.

Assess the Benchmark returns

You need to evaluate the magnitude of the returns because profits are usually higher when you invest in bigger positions. Many traders use the Sharpe Ratio to benchmark. The ratios assess your strategy and place it into the larger context, telling you how much volatility and risk you took to get the returns you are getting now. The bigger the Sharpe ratio, the better because it means the returns are high and the volatility is low.

Other factors you need to look at include the average returns per trade, drawdown for tail end risk and the average holding period.

Conclusion

Trading takes many forms, and it is dynamic as well. Times change and with the change, markets and operational methods also change. With the advent of computers, it was logical that trading would become better and faster. This came to pass, and traders now have the capacity to trade on the go and use programs that make trading easier.

One of the best methods to use to run trades with more confidence is Algorithmic trading. This makes use of mathematical calculations to help you predict trading actions. When you do this, you eliminate various errors including the emotional aspect of trading that tends to affect the outcome of trades. Success is all about knowing when to place a trade, how much you need to invest and the right platform to use for trading.

While you can come up with your own system, it takes time and the best way can be going for a ready-made system that gives you the capability you are looking for. We have discussed the various systems that you can use and the advantages of each system. Most of the systems give you a trial period that you can explore before you make the decision to take it up or not.

Finally, we looked at backtesting. Backtesting is an ideal way to use historical data to come up with assumptions about the future. Since you are using facts to determine the future, you stand to reduce many errors in future trades.